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Editorial Comment

Regarding Public Companies What goes on "behind the scenes" during the period immediately preceding the publication of the prospectus of a public company is the subject of a paper this month by James Kilpatrick, F.C.A., one of the leading members of the profession in Great Britain. The accountant, as Mr. Kilpatrick states, plays an important part right down to the issue of the prospectus, being constantly engaged with the sponsors to the issue, the solicitors to the company and to the issuing house, the brokers and the vendors. His paper will be read with interest by all and will be of particular benefit to the younger members of the profession.

When a compromise or arrangement is proposed between a company and its shareholders affecting the rights of shareholders or any class of them, certain rules and forms of procedure must be followed as set out in section 122 of the Dominion Companies Act or in a somewhat similar section of most Provincial companies acts. In recent months the subject of company reorganization has been brought to public attention by a number of court cases, and an article on the subject prepared by James T. Gow, a regular contributor to our legal column, is published this month.

*Obstacles
To Export
Trade*

Conditions as they actually exist for the Canadian manufacturer exporting his products to countries such as Italy, Germany and South America, and some of the obstacles encountered were the subject of an address recently given at a meeting of the Society of Cost Accountants in Toronto, by Walter Lattman of the Massey Harris Company. Mr. Lattman has an expert knowledge of seven languages and has travelled in many parts of the world in the interests of his company, and much of the material of his address was taken from his own experiences. The difficulties attaching to trade with some foreign countries are almost incredible, and our readers, we are sure, will find interesting the summary of his address published this month.

It was because of the ever-increasing obstacles placed in the way of the exporter that the governments of the United Kingdom and France a year ago asked Paul van Zeeland, former Premier of Belgium and world famous banker, to report on "the possibility of obtaining a general reduction in the obstacles to international trade." Mr. van Zeeland has made investigations in several countries including the United States, and a summary of his report appeared in *The Economist* (London) of 29th January last. It is an instructive survey of the problem with suggested solutions, and a study of it by our readers will be found well worth while.

*Economic
and Finan-
cial Factors*

The factors which most seriously prejudice international trade, according to the report, are to be found in the so-called economic sphere and in the financial sphere. Chief among the former are tariffs, methods of indirect protection and quotas, while among the latter are sudden and excessive exchange variations, hindrances to capital movements and restrictions on payments. Of the first group, quotas, in the opinion of Mr. van Zeeland, are one of the most formidable obstacles to the development of international trade, and as years go by their arbitrary and artificial character becomes more and more evident. Referring to agricultural quotas, in which a nation like our own is interested, he points out that in times of crisis, agricultural production cannot adapt itself to the contraction of demand with the same elasticity as is possible with industrial production. As is often the case, the agricul-

tural community in order to meet the fall in prices shows a tendency to increase the volume of its production, thus creating a greater surplus which has to find outlets abroad—where free markets have of late tended to diminish to the vanishing point.

Of all the obstacles in the financial sphere, states the report, there are none more harmful and more formidable than those which arise either from monetary disturbances or from restrictions regarding the transfer of capital or of commercial payments. Referring to the various types of restrictions on the transfer of funds from one market to another, it is pointed out that not only have the debtor markets adopted such measures, but also the creditor markets. By forbidding or restricting foreign lending, the latter have deprived international trade of a valuable support.

What Are the Remedies?

The van Zeeland report makes a real contribution towards the formulation of a plan for greater international collaboration. If tariffs, quotas, exchange fluctuations, currency controls and all their attendant evils are to be overcome, there must be a willingness and an agreement of the nations to this end. The report suggests a preliminary meeting of the principal economic powers to consider the possibility of agreement on some general principles. We cannot deal here with all the recommendations for remedying the present unfortunate situation, except to state that the most important are the gradual lowering of tariff barriers and the suppression of quotas by reciprocal agreements; the stabilizing of exchange by the extension to other countries of the so-called tri-partite agreements of 1936 between Great Britain, France and the United States; the dealing with arrears of payments in the clearings by means of long-term credits and gradual amortization, and the bringing into use of the Bank of International Settlements as an instrument to overcome exchange difficulties. Whether or not any action can be taken on the report in the near future remains to be seen. It is for the nations of the world to say whether they will alleviate or perpetuate the present intolerable difficulties.

Reciprocal Trade Pacts

Every effort to remove the trade barriers between this continent and the rest of the world will be welcomed by the farmers of Canada and the United States. It is to be hoped, then, that political conditions in Europe will not

affect adversely the reciprocal trade agreements now under discussion between Great Britain and the United States. Speaking in the Middle States at the end of February on the proposed agreements, Secretary Cordell Hull of the United States said that the re-building of international commerce and consequent world-wide benefits depended to a great extent on the success of negotiations for this trade agreement between his country and Great Britain. Any sound program for broadening the markets for farm products at home and abroad, he said, was in the interest of agriculture, and to no other group of the population was foreign trade of greater significance than to the farmer. The crucial factor in the farm problem in his country is how to find markets at home and abroad for the vast and productive acreage. Unless this is done, the pressure of large surpluses and low prices for farm crops will force the diversion of land and labour now devoted to their production into dairying and other branches of agriculture not on an export basis, and thus increase the pressure of internal competition upon prices in these branches as well. Only healthy international trade, Mr. Hull said, will make possible a full and stable domestic economy.

*Future
Prospects
of Wheat*

From these references to the shackles on world commerce and to the need of markets for the exportable surplus of agricultural products, there naturally arises in our minds the question as to what the future has in store for Canadian wheat. According to *Canadian Finance* (Winnipeg) evidence is piling up to indicate that the drought cycle in Western Canada has passed. The precipitation record of last autumn was better than it has been for years; in Alberta and Manitoba it was somewhat above normal while in Saskatchewan it was eighty-one per cent. of normal, a higher percentage than was registered in any fall since 1933. Prospects of a good crop in 1938 are better than they have been for some time. The prairie provinces, and in particular Saskatchewan, have waited long for a crop and it is to be hoped that their patience and faith will be well rewarded this year. Yet, if an average crop is harvested, what are the farmer's prospects for a good financial return? According to a recent bulletin of the Alberta Wheat Pool, the grain grower must not allow himself to become too optimistic over the future of wheat. "It appears obvious,"

the bulletin states, "that unless continental European countries change their wheat policies and permit a freer ingress of wheat, or unless disaster overtakes the European crop next year, the world wheat situation will be serious. World trade is not stepping up sufficiently fast to take care of the potential excess in exporting countries. First class crop disasters, such as occurred in Western Canada this crop year and to a lesser extent in Argentina, cannot be expected to continue endlessly and thus curtail the supply to conform with the world demand.

"Conditions now existing in Western Canada are much more favourable to the production of a crop in 1938 than they were a year ago. Quite substantial areas of the western wheat belt have received good supplies of moisture . . . This would indicate that chances for at least a fair crop next year are good.

" . . . The large carry-over has been cut down to normal; the Canadian Wheat Board has disposed of its supplies; no exporting country is trying to maintain domestic wheat prices by artificial means. Yet world wheat trade still stagnates."

The Alberta Wheat Pool has thus sounded a timely warning. The Canadian farmer, with his surplus of agricultural products for export, often does not take the trouble to look beyond his locality or his province for the causes of low prices. It is unfortunate that it is so; for when crops are good he is prone to regard a government as unsympathetic that does not establish a fixed price for his wheat, and the banker as dominated by "the moneyed interests" if he does not grant loans in excess of what market prices warrant. As a result, the local banker in the mind of the farmer and the politician has to bear the responsibility and the blame for depriving the people of "purchasing power"—one of the most abused and least understood terms of the day.

*What Is
Purchasing
Power?*

We perhaps should apologize to the farmer for singling him out in this way. However, a statement made recently in all seriousness by a prominent government executive on this continent would indicate that the habit of not looking beyond immediate circumstances in our economic relations is not the monopoly of any one person or

group. This executive stated that he was opposed to wage reductions because the markets of industry depend on the purchasing power of the working population, and if prosperity is to be restored that purchasing power must be increased not decreased. And speaking of prices he said that since a mass-production industry depends on volume for profits the only way to get volume is to produce goods for a price the public will pay; but if the industry decides to ask for its products a reduced price which the people can afford to pay, it does not mean that such price reduction can come out of wages.

This raises the question of what purchasing power really is and the part the industrialist plays in the creation and distribution of purchasing power. As an approach to the subject let us think again of the farmer of British Columbia, or Manitoba, or Nova Scotia who comes to market with his load of fruit or vegetables. By his labour he has brought into existence something of value that can be exchanged (whether by barter or through the medium of money, it does not matter) for something else of value, and in this way he has created "purchasing power." What must be kept in mind is that the farmer has produced something that another person needs and is willing to pay for, and that in its production he is able to command other things of value. In a similar way the manufacturer in any one of our Canadian cities creates "purchasing power." He brings in, or is instrumental in bringing in, an assortment of materials and converts them into finished goods for which consumers will pay more than they would have been willing to pay for the materials from which the goods are made. The difference between the value of the materials and the value of the finished goods is a creation of the manufacturer (and those associated with him) and can be employed by him in commanding other things of value. This difference represents purchasing power which has been created by the manufacturer only by producing goods of value which did not previously exist.

*Distributing
Purchasing
Power*

If the manufacturer required the assistance of no one in his operations the difference between the value of the materials and the finished product would be his; but like other industrialists of today he had associates, which means that the finished goods are the joint product

of individuals who co-operated with him. In the first instance, the manufacturer visualized the possibility of turning out goods more valuable than their cost of production, and he assumed the risk of doing so. He secured the assistance of others in carrying out his operations and paid them specified amounts, and in this way much of the purchasing power created was distributed to wage-earners, to banks for their services, and to others. The important thing is that he, like the farmer with his wheat, the miner with his ore, and the fisherman with his "catch," created the purchasing power in the production of marketable articles. When he paid the cost of their production in the form of wages and other expenses he merely distributed purchasing power in the process of their creation.

In the opinion of the executive, to whom reference has been made above, if the manufacturer finds that he must reduce prices below cost of production before products can be sold, he must nevertheless continue to produce at existing wages. This means that he will be obliged to distribute more purchasing power than he creates. It is obvious that this process can continue only so long as he can draw upon reserves which he may have accumulated in the business or may have previously contributed thereto. When the point of exhaustion comes the distribution of purchasing power ceases. To expect or to demand a continuation is analogous to denying that the widow who gives her last dollar to the tramp at her door has reduced her own purchasing power in the same measure that she has increased his. He spends it on food, but the poor widow must go hungry.

Among the participants in the purchasing power created in the manner above described are our governments who appropriate to themselves a share of it by an almost infinite variety of taxes. The governments in turn distribute it in many ways—as salaries to civil servants and officials, as pensions, unemployment relief and bounties, and as expenditures for numerous other public services throughout the Dominion. As at bottom governments cannot pay out more purchasing power than they receive, the significance of a "balanced budget" is apparent. The issue of government bonds to meet the excess of expenditures over revenues is fundamentally a temporary expedient; if repeatedly resorted to without any effort at redemption, repudiation

of these obligations in whole or in part by governments will be the eventual outcome—which is only another form of taxation, the unfortunate holder of the bonds being the taxpayer in that case.

In spite of the simple principles which are the basis of this subject, one hears on every hand public speakers, and prominent people who certainly should know better, contend that banks and the government "create" purchasing power.

*April and
Income Tax* April has come to be regarded as income tax month, and we publish in this issue some articles and memoranda which should prove helpful to the taxpayer. It is evident from a perusal of Mr. Gordon's paper on taxes in Canada, Great Britain and the United States that a great amount of study and care was required in its preparation. "At the present time," he states, "a wealthy man may be better off to conserve his capital than to attempt to increase it. If he tries the latter course he must be prepared for the ordinary risks of loss if he is unsuccessful; if he is successful he must be prepared to have a large part of his reward taken from him in the form of taxes. People are not inclined to take chances with their money unless the rewards for success are attractive." What part do governments play in encouraging or retarding industrial development and commercial enterprise? Mr. Gordon's paper will help the reader to come to some conclusions on the question.

THE AUDITOR, THE CLIENT AND THE PUBLIC*

By Howard I. Ross, Chartered Accountant,
Montreal

THE auditing tradition may reasonably be called a highly conservative one. A tendency to caution in the profession has developed naturally and inevitably out of the nature of the work undertaken. Preoccupation with thoughts of this conservative tradition has often obscured the fact that during the past fifty years the problems and technique of auditing have changed more, possibly, than those of any other profession.

Interesting references to accounts and their checking in ancient times are occasionally unearthed but it remains true to say that auditing, in anything like its present day form, is very young indeed as the age of professions is measured. When examined, the whole development of auditing as we see it today begins to seem almost unbelievably recent. Many examples of this fact could be quoted. For instance, an auditor who is still practising today can remember taking part in the first independent audit of a banking institution ever undertaken in the city of Philadelphia when the institution was not in financial difficulties. So revolutionary was the idea and so fixed in the public mind was the conception of the auditor as a sort of "financial coroner" that the audit had to be conducted with the greatest secrecy to prevent the danger of a run on the bank.¹ Compare this situation where the auditors crept stealthily into the bank after dark with the situation today where the absence rather than the presence of independent auditors would be a cause for alarm. This comparison indicates the changing position of the auditor.

At the outset it may be well to point out that the new problems and technique of auditing do not necessarily imply a change in the fundamental principles of accounting on which auditing is based. The maxim "anticipate no profits and provide for all losses" is possibly one of the oldest accounting principles. This principle probably remains as true today as it ever was, but it must be applied to conditions which are changing almost daily. It is this

*NOTE: As reported in our January issue, Mr. Ross' essay won the prize of \$35 in the 1937 Essay Competition.

¹T. E. Ross in *The Journal of Accountancy*, October 1937.

question of applying recognized principles which raises some of the most difficult features in the work of auditing.

It is the purpose of this essay to suggest some of the implications of the changes which have taken place in the business and financial world in which the auditor works. It will also be suggested that one of the most urgent needs in the present situation is that auditors should make clear to clients and to the public in general the possibilities, limitations and new problems from the auditing point of view that have arisen with these changes.

The Growth of Commercial Enterprises

The fundamental difference between the industrial and financial world of today and that of fifty years ago is probably a difference in the size of the individual enterprises which make up this world. This great increase in size has meant, to begin with, that the feasibility of doing an audit in complete detail has often disappeared. However, there is another very important aspect of the change which may sometimes be overlooked. The point is that by increasing in size the fundamental nature of business enterprises has been changed in two important ways. Firstly, we talk of public utilities and private companies, but to a large extent every large company may be considered a public institution. After it has attained a certain size the welfare of almost any company becomes a matter of public concern. In Canada today newsprint companies, oil companies, some department stores, all banks, and many other institutions have become large enough to be virtually public institutions. Large groups of people employed by any one of these companies are obviously interested in its welfare; also large groups of people who sell it supplies; also large groups of investors in institutions which hold the company's shares; also large numbers of policy holders in insurance companies which have invested funds in the company; also the government which derives by taxation income from the company; also practically everybody else within the country who would more or less indirectly suffer by the failure of the company. In a word, there has been a tremendous increase in the inter-dependence of all companies and of all classes in the community. Secondly, the larger scale on which many modern companies operate has made these companies more impersonal. In former days it was probably custom-

ary for the shareholders of a business either to operate the business personally or, at least, to have some personal knowledge of the management. Today the shareholders are frequently scattered over large areas, possessing no first hand knowledge of the company's management. The increasingly impersonal nature of business has consequently had the effect of making shareholders more and more dependent on the financial statements which they receive. These statements often constitute the shareholder's only source of information concerning his investment.

These two changes—the increasingly public status of industry and the increasingly impersonal nature of business—have affected the position of auditors. For one thing the responsibility of auditors has been extended morally if not legally to wider fields. There may possibly be some question of the auditor's liability to persons with whom he has no contract—i.e. creditors, banks, governments, etc. The point, however, of the liability for damages is not one which is important for the purpose of the present essay. Regardless of the legal view of the matter, the fact remains that the auditor has a moral obligation to an increasingly large number of people, and an obligation which he must fulfil if the profession is to maintain the position it now enjoys in public esteem. In the second place, the auditor has become more important to the shareholders as he has been charged with the task of verifying the financial statements which frequently form the basis of the shareholders' knowledge of the company and its operations.

Limited Liability

At this point it may be well to stress the fact that one of the most significant features in the growth of financial and commercial enterprises in the past century has been the introduction of the conception of the limited liability company. A hundred years ago, the joint-stock company was still regarded with suspicion. In 1828 an English judge apparently summed up the general attitude of the courts towards ordinary joint-stock companies when he said, "The scheme in which the parties to this action were engaged was one of those bubbles by which, to the disgrace of the present age, a few projectors have obtained the money of a great number of ignorant and credulous persons, to the ruin of those dupes and their families, and by which a

passion for gambling has been excited, that has been most injurious to commerce and the morals of the people . . . no one doubts, if it can be shewn, as it easily may, that such schemes are fraud-traps and injurious to the public welfare, that the forming of them is an indictable offence at the common law."² This was more than a century after the famous panic caused by the bursting of the South Sea Bubble. Apparently the old wound still smarted, which would seem to indicate that the market operators of those days had rather less resiliency than some of the speculators of our own time. However, the South Sea Bubble was eventually forgotten as it became more and more apparent that the joint-stock company was one of the fundamental necessities in the expanding commercial life of the times. Governments gradually appreciated both the useful purposes which joint-stock companies could serve and the necessity for legislative action. A series of statutes was passed in England governing the incorporation of these companies until in 1855 limitation of the liability of members was conceded.³

In granting the principle of limited liability parliament raised many problems some of which have yet to be satisfactorily solved. Broadly these problems may be said to fall under three headings—the protection of the creditor, the protection of the investor and the protection of the shareholder. The protection of the creditor involved the enactment of legislation to prevent the creditor's margin of safety being impaired by the surreptitious withdrawal of capital from the company. This problem (logically the first problem to settle) has very largely been met in so far as legislative action can meet it. The problems of protecting the investor and the shareholder are comparatively much more difficult of solution. Statutory efforts have been made to compel companies to produce informative and accurate statements, certified by independent auditors, so that reliable information will be available for investors and shareholders. Much has undoubtedly been accomplished and improvements are being made almost annually. Nevertheless, no one can seriously doubt that statutory regulation will always have its limitations. In the last analysis

²Quoted in Wegenast *The Law of Canadian Companies*, pp. 17-18.

³*Ibid.*, p. 18.

the safety of the shareholder will depend on the judgment and integrity of the management and of the auditor.

"Charitable Donations, Audit Fees, Etc."

In view of the responsibilities placed on the shoulders of auditors by the position in which they find themselves today, it would seem important that they should consider how far they are fulfilling their responsibilities and in what direction improvement might be effected. As has been suggested previously, it is part of the thesis of this essay that one of the most imperative tasks for the auditor today is the educating of client and public on the subject of the problems and possibilities in modern auditing.

There is a Canadian company whose general ledger contains a sundry expense account headed "Charitable donations, audit fees, etc." It is hoped that this unhappy grouping of expenditure is neither logical nor typical. Auditors would like to think that when a client pays their fees the expenditure has no connection whatever with Faith and Hope's extremely worthy but rather unattractive sister. Nevertheless auditors have from time to time expressed the view that clients were sometimes quite vague on the subject of the value to be gained from having an audit made of their accounts. It has been pointed out that in some cases the client's only contact with the auditor has been through the receipt of a formal report and statements occasionally qualified concerning some of the most interesting figures. It is perhaps too frequent that the client receives such report, with, possibly, a list of missing vouchers, a series of rather technical closing entries which he has to make, and a request to sign a certificate substantiating the correctness of the inventory.

Education of Client

This unsatisfactory situation points pretty clearly to one of the fundamental problems of modern auditing—namely, the education of the client. There are two things about which auditors must educate the client. The first of these concerns the accounting terms and principles which are embodied in the statements. These terms are frequently more technical than they need be, and possibly there has been some failure, speaking very generally, amongst auditors to realize the layman's difficulty in understanding terms which are very familiar to the auditors.

Many would probably agree with Hodgins, J.A. when he said *In re Owen Sound Lumber Co.* (1917) "The terminology used by accountants may be an aid to their business, but it is a barrier to understanding." In the second place, there is a great need to educate laymen in general concerning the possibilities and limitations of an audit. The auditing profession is threatened from two sides — from the enthusiasm of those who feel that an auditor can verify everything, and from the skepticism of those who feel he can verify nothing.

It would be interesting to know what registers in the average layman's mind when he reads, at the foot of a balance sheet "We have audited the accounting records, etc." On some points the client might be surprised how much an auditor can do in establishing the correctness of a figure, and on others how little. There has been far too little appreciation by the public in general of the real nature of auditing. There are undoubtedly investors who have never paused to think of the difference, from the point of view of verification, between, say, cash and inventories. In the past accountants have spent much time in studying and discussing the technical questions connected with their profession. This discussion is excellent and has led, presumably, to great improvement in the standards of auditing technique. There remains much to be done along these lines, but it would also be advisable to spend more time looking at auditing from the client's viewpoint—which is, after all, a very important viewpoint.

The Auditor's Report

There have been some changes in the Auditor's Report in the past few decades but on the whole the report (or certificate) has been changed surprisingly little in view of the changes in audit technique. Clients reading the report might well be excused for failing to grasp the changes which have taken place. As has been pointed out above, fifty years ago the typical business was probably managed by the owners. The owner was chiefly interested not in the operating results with which he was familiar, but in the honesty of his clerks. The auditor's main duty was to act as a fraud detector. Today in large businesses, systems of internal check have been devised which make the auditor's activities as a detective relatively less important

than they were. On the other hand the increasingly impersonal nature of business has made, as we said above, the auditor more valuable from the point of view of ensuring the publication of proper statements. There may be those who are inclined to point out the existence of large firms fifty years ago and of small firms today. There is no doubt whatever of the reasonableness of this contention; however, it remains true to say that the typical problems of modern accounting may be said to result from the general increase in the size of business units.

The Fraud Detector

The auditor probably first became prominent as a cash checker. This conception of the auditor is dying very hard indeed. In the public mind we are still to a large extent the conscientious, painstaking, checkers of additions. There is no general appreciation of the opportunities for judgment, for ability to grasp complex situations, and even for imagination in the work of the present day auditor.

If the client could be made to appreciate the sort of work which an auditor does, the profession would have made a progressive step. There would be a greater tendency to derive benefit from the auditor whose variety of experience well fits him to assist the management on various questions. At once, let it be said, this does not imply that the auditor is a business expert or that he should give advice on certain matters of policy which the business man knows more about than he does.

Routine Checking

The more general appreciation of the change in the auditor's position should be an important objective for auditors. No one enjoys being thought of as a dull, uninspired plodder but the question is not merely one of personal pride. The present conception of the auditor forces him to do a great deal of work which he knows is not as valuable as other work which he might do. For instance, it would be interesting to know how many hours are spent each year by auditors in Canada in checking cash book additions. The figure of the number of hours would be an interesting one with which to compare the value derived from such work. Obviously some test of cash book additions should be made, but the question is, does the client really receive value for all the time so spent? Could other

work not be done more profitably in this time? Probably most auditors spend more time than they really consider useful on cash book additions, general ledger postings, and other similar routine work. This additional time is obviously not spent because the work becomes so gripping that the auditor cannot bring himself to lay down his red pen. The real reason in certain cases for doing some of this routine work would appear to be that the auditor is safeguarding himself. If the auditor were sued as a result of failing to detect a fraud and was asked in Court whether the cash book had been added he would stagger Judge or Jury if he replied that the cash book had not been added. The popular misconception of the auditor's work would have been his undoing. This popular misconception, then, is one which may very materially hamper the auditor in his work.

It may be said that a great number of clients have a very keen appreciation of modern auditing technique. This may well be so, but this informed opinion is not universal, nor even as widespread as it might be if the process of educating clients and public was advanced.

It may also be urged that cash book additions form fine training for juniors. This argument has obvious merit, and it is only urged here that too great a percentage of an auditor's time is consumed in these routine matters. This is particularly true in Canada today where the audit frequently takes the form of a race against time, and the main problem of the auditor is the apportionment of a limited time allotment over the various aspects of verification open to him.

Another argument against a reduction of various routine verifications might be that the auditor is peculiarly responsible for the mathematical accuracy of statements. One auditor practising fifty years ago used to start his juniors on their way to work with the maxim "Take Nothing For Granted." This sound advice would be very difficult to apply in all present day audit situations. The fact must be faced that in the time at his disposal the auditor has not the opportunity to probe every transaction to its very roots. A good auditor develops the art of appraising the relative importance of different possible checks and spreading his time over them as reasonably as may be.

It is no part of an auditor's business to predict the future, his work being more concerned with interpreting

the past. However, if past trends mean anything, the profession of accountancy is moving into an increasingly complex environment. New problems of taxation and statutory regulation seem bound to increase the difficulties and possibilities of the profession. In view of this situation it would appear to be an opportune time to clear up some of the misunderstandings with client and public which tend to confuse the issue today.

PROSPECTUSES OF PUBLIC COMPANIES—BEHIND THE SCENES*

By James Kilpatrick, Chartered Accountant,
London, England

WHEN the Convener of the Syllabus Committee extended the invitation to me he left the choice of subject to myself, and I have chosen my subject for the following reason. Many of you probably have been engaged in an investigation of the books and accounts of a concern with a view to reporting on the profits for the purposes of a public issue, but as the partner in charge of the investigation may have himself dealt with the work subsequent to the actual completion of the detailed report you may not have had much opportunity of seeing what goes on "behind the scenes." The accountant's duties in this regard are both important and onerous. I do not know whether, say, a quarter of a century ago the accountant, after having given his certificate regarding the profits, was called on to do much more, but certainly nowadays he plays an important part right down to the issue of the prospectus, being constantly engaged with the sponsors to the issue, the solicitors to the company, and to the issuing house, the brokers and the vendors.

I will endeavour to describe to you the interesting period immediately preceding the publication of a prospectus.

*A paper read before the Glasgow Chartered Accountants Students' Society on 24th November 1937 and before the Chartered Accountants Students' Society of Edinburgh on 6th December 1937. With the consent of Mr. Kilpatrick, that part of his address dealing with stamp duties on the formation of companies in Great Britain has been omitted.—*Editor*.

We will imagine that the owners of a private business have, possibly for family reasons, possibly for taxation reasons, decided to realize some of their interests therein. Perhaps they do not know the best method of achieving their object, and they ask the advice of their bankers or auditors. (Unfortunately, not everyone takes this precaution—one hears occasionally of owners of businesses being rushed into very unwise deals by plausible so-called financiers.) Their advisers put them in touch with a reputable financial house, and armed with the detailed trading and profit and loss accounts and audited balance sheets for a series of years they have a preliminary meeting. If the financial house express themselves as being interested, after hearing what the proposals are, they probably intimate that they would like to have a report on the business from an independent firm of accountants who would require to be given full facilities for their investigation. Sometimes the auditors to the concern are asked to make the investigation and report, either alone or in conjunction with an independent firm. The period to be covered by the investigation might be agreed upon or this might be left to the discretion of the accountants. Other matters such as a possible form of capitalization, the terms on which the issuing house are prepared to undertake the issue, and the estimated cost are possibly touched upon, and it may be arranged that subject to the receipt of the report from the accountants and a valuation by expert valuers of the fixed assets, and there being no change in the financial situation by the time the issue comes finally to be decided upon, the issuing house will be prepared to make the issue.

This is not a lecture on the conduct of an investigation by the accountants and I do not propose to discuss the many points which they should bear in mind in carrying out their enquiry. The detailed report to the issuing house would probably start with a history of the concern and then go on to deal with the financial position as at the date of the last audited balance sheet and give full information regarding capital, reserves, liabilities and assets. The next part of the report would deal with the trading results for the series of years, and much of the detailed information would probably be given in the form of appendices to the report. If it is available, information regarding the

results of the business from the date of the last accounts down to the date of the investigation would naturally be given. The accountants will probably conclude their report by submitting a draft certificate as to profits and net assets with the qualification that it is subject to the production of the valuation of the fixed assets and to a perusal of the draft prospectus.

Prospectus and Problems of Flotation

During the period of waiting for the report from the accountants, the issuing house will probably have been discussing details with the owners of the business and will have set up a prospectus in skeleton form and a draft set of the Memorandum and Articles of Association of the company. As one of the objects of the issue will be to obtain permission from the Committee of the London Stock Exchange to deal in and in due course to get an official quotation for the stock or shares of the new company, the Memorandum and Articles of Association will require to contain certain provisions to meet the requirements of the Stock Exchange. These provisions, *inter alia*, are that directors' qualification shareholdings must not be merely nominal, borrowing powers of the directors should be limited to a reasonable amount, nonforfeiture of dividends is secured, common form of transfer must be used, there must be no restriction on transfer of fully paid shares, all share certificates must bear the common seal of the company and bear the signature of one or more of the directors and the secretary, that fully paid shares shall be free from all lien. These are not necessarily all the requirements, and in short the committee may take exception to any clauses in the Articles which might in any way restrict free dealings in the shares or in the committee's opinion be unreasonable in the case of a public company.

The issuing house have now to consider how best to carry out the flotation of the new company. There are several methods: (a) by means of a prospectus the company offers its shares for public subscription either direct or through the issuing house or a bank: (b) by means of an offer for sale the issuing house offers the shares to the public where such shares have been allotted by the company to the issuing house with a view to their being offered for sale: (c) by means of a private placing of the shares

by the issuing house in which case particulars of the issue are advertised to comply with the regulations of the Stock Exchange, but no invitation to the public is made.

In the case of (c) there is considerable saving in advertising as the particulars of the issue need only be advertised in two newspapers. If the issuing house have a good clientele, including investment trusts and insurance companies, who are generally quite ready to invest their funds in good class shares, it may suit them to place the shares privately with such clients through a broker.

After having seen the draft of the Accountants' Report and a Statement of the Adjusted Profits and Net Assets, the issuing house may have to modify their original suggestions as to the proposed capitalization of the new concern, conditions in the financial world may have altered and it is more than probable that there will be numerous discussions with the vendors on the matter. There will be the question of the voting rights of the various classes of shares, whether it should be a condition that a general reserve should be built up to a certain figure before a dividend in excess of a certain percentage is paid on the ordinary shares; if a debenture issue is contemplated the names of the trustees, whether the vendors should guarantee that the profits for one year following the incorporation of the company will not be less than a certain figure; whether the vendors should guarantee that the book debts will realize at least the amount taken over by the new company. The question of the purchase consideration will also have to be agreed and the amount to be taken in cash and/or shares by the vendors, settled. The issuing house may make it a condition that the vendors are not to sell the shares which they receive as part consideration, for a period of one or more years. They may also wish to have the right to nominate a director to the board. Allied to the question of the purchase consideration is that of goodwill. The issuing house naturally wish to see that the cover for the debentures, preference shares or ordinary shares as the case may be is adequately represented by tangible assets. It is true that in the case of some concerns earning handsome profits with very little to show in the way of tangible assets, they can be successfully floated and a large figure for goodwill shown in the prospectus, but generally speaking, an attempt is usually made to keep the item of

goodwill as low as possible. This is the only asset which under the Companies Act must be separately specified on a prospectus. One method of reducing the figure for goodwill is to decrease the nominal amount of shares issued in payment of the purchase consideration, these being sold at a premium in the subsequent offer for sale. Part of the goodwill thus would be shown in the offer for sale, part is wrapped up in the price at which the shares are offered. In the case of the company itself making the issue it may be considered desirable to issue the shares at a premium, and if so, such premium can be utilized in writing down goodwill.

Preliminary Expenses and Working Capital

The issuing house will have judged from the accountants' report whether the concern is in need of further working capital, and will question the vendors very closely in this regard. This is one of the matters which is required to be stated in a prospectus. You may remember in accordance with Part I of the 4th Schedule to the 1929 Act, there must be stated the minimum amount which in the opinion of the directors must be raised to provide the sums necessary to defray (a) the purchase price; (b) any preliminary expenses and any commission; (c) repayment of any moneys borrowed by the company in respect of any of the foregoing matters and (d) working capital.

I have frequently heard comments that the preliminary expenses and costs of an issue are usually far too high. It is a matter for arrangement naturally whether these are borne in whole or in part, (a) by the issuing house; (b) by the company or (c) by the vendors. The following will give you an idea of what the preliminary expenses on the formation of a company and an issue of, say, 150,000 shares of £1 each might amount to:—

	£
Stamp duty on share capital	750
Printing Memorandum and Articles of Association ..	150
Advertising prospectus	4,000
Underwriting and overriding commission @ say, 4%	6,000
Brokerage @ say, 3d. per share	1,875
Printing prospectus	300
Posting prospectus	100
Printing allotment letters and stamping	150

Fees of solicitors to the issuing house and solicitors to
the company, accountants, stockbrokers and bankers 2,750

£16,075

The foregoing is of course exclusive of the fee payable to the issuing house. Where however the issuing house first purchases the shares from the vendor at a price and subsequently sells or places the shares at a higher price, the "turn" which the issuing house makes on the transaction may constitute their sole remuneration for handling the issue. The above figures also do not take into account any inter-vendors' profits. In a small issue the percentage of the total cost to the capital to be issued is relatively higher than in a large issue, as the cost of advertising is probably as heavy in the case of the former as in the latter.

Continuity of Management

The future management of the new company will be of considerable importance. You will have noticed how frequently there appear in prospectuses the words, "Continuity of management is assured." If the success of the business in the past has been largely due to the old management, it would not be a very good point from a prospectus point of view if the directors were simply selling out and not taking any part in the management in the future. Discussions will therefore take place as to the terms under which the old management will continue. If the vendors are directors and are going to retain a considerable portion of the purchase price in the form of ordinary shares in the new concern (which may be a measure of their confidence in the future of the business), they may be content to rely on the dividends they expect to earn rather than on large salaries. The smaller the salaries the greater will be the finally adjusted profits and the yield on the ordinary shares. Sometimes it will be found therefore that if the yield on the shares is not going to be particularly attractive after charging management remuneration, rather than reduce the proposed capitalization the issuing house will suggest a reduction in the amounts to be paid to the management in the future by way of fixed salary, but with a percentage of the profits in excess of a certain figure. The solicitors will be asked to draft management agreements, and it is always advisable to have these submitted to the

accountants for their comments. As I am sure you are aware, there is more trouble over the interpretation of "profits agreements" than with most other contracts. The accountants should see therefore that the expression "profits" is clearly defined and that the agreements carry out the intention of the parties.

The Articles of Association have now to be finally approved and the amount of directors' remuneration (apart from the management remuneration) inserted in the appropriate Article. There may be other contracts involving payment for services, such as secretary, registrar, etc., and the terms of these having been finally agreed, the accountants will be able to complete the part of their report relating to profits after having seen the valuation of fixed assets by the valuers, and determined the depreciation to be charged. Very frequently the accountants in their report state the profits before charging depreciation and management remuneration, leaving these items to be shown as a deduction in the body of the prospectus. Unless there is any good reason to the contrary, I think everything which will be a charge against the profits should be deducted by the accountants in stating the adjusted profits, and it is important to remember that the charge for depreciation which will require to be provided in future should be based on the cost of the assets to the new company and not upon their book value in the balance sheet of the vendors.

Report on Profits Formerly Optional

May I digress for a moment on the subject of the Accountants' Certificate of Profits—since the passing of the 1929 Act the words "Report on Profits" are more widely used. Prior to the passing of that Act there was no statutory obligation to publish in prospectuses the trading profits for a series of years. Where the information was available it was, however, the usual practice for Accountants' Certificates to be embodied in the prospectus giving the profits and a statement of the financial position. Unlike the Report of the Auditors on a balance sheet which follows the wording of the Companies Act (subject to any qualifications they may wish to make) the Accountants' Certificate for prospectus purposes does not rest on statutory wording; it is drawn up by the accountants, and they are solely responsible for the manner in which it is framed. Thinking it would

be of interest to you, I have had access to a number of prospectuses issued over thirty years ago, and I quote below the certificates by the accountants thereon. Some of them appear strange in the light of present-day practice:

We have examined the books of the Company, Limited, from the date of its incorporation, 25th February, 1898, to the 31st October, 1901, the date of the last certified Balance Sheet (three years and eight months), and find that the profits earned have averaged £95,815 7s. 2d. per annum.

The profits of the first year and ten months, to 31st December, 1899, exceeded the amount required to pay the interest on £150,000 Five per Cent. Debentures, and 10 per cent. per annum on the £250,000 Share Capital of your Company. The profits for the year 1900 considerably exceeded the average, and those for the last 10 months, to 31st October, 1901, were also more than the average.

In ascertaining the above profits (from which dividends and interest received have been excluded) a proper allowance for depreciation has been made and all other expenses of the business have been charged, except Managing Director's Commission and Bonuses voted by the Shareholders to the Directors and Staff.

We have examined the books of the 13 Vendor companies and firms for the last three completed years of each business, and we certify that before charging Interest, Directors' and Managing Directors' remuneration and Trustees' fees, the annual average Profit amounted to £1,062,922. All Working Expenses, Bonuses paid to Employees, Depreciation on Plant, Machinery, Fixtures and Fittings have been charged before arriving at this Profit.

We have regularly audited the Books of Messrs. and Co., of, since the commencement of their business in December, 1895, and we certify that their annual Net Profits from the sale of Pure Bitumen Damp-course, Pure Bitumen Sheeting, and Damp Resisting Solution have, ever since, steadily increased; and that for the year ending December 31st, 1902, they amounted to £5,057 5s. 6d.

We have continuously audited the Accounts of Messrs. and Co., of, for more than twenty years; and we certify that, notwithstanding the serious incon-

venience and dislocation of business, naturally caused by the partial destruction of the premises by fire, in August, 1898, and the subsequent rebuilding, the net profits in any of the last five years were sufficient to pay the Interest on the present Debenture Issue and the Dividend on Preference Shares, and to leave a very substantial balance for dividend on Ordinary Shares.

"In the year ending the 20th January, 1903, when the Factory premises also were in the builder's hands for the whole of the year, the net profits amounted to £11,688, or, without taking into account Directors' fees, practically double the amount required to pay:—

The Interest on £65,000 Debenture Stock at 4	
per cent.	£2,600
The Dividend on £70,000 Preference Shares	
at 5 per cent.	3,500
	<hr/>
	£6,100

These profits are arrived at, after excluding rents of the premises, now acquired by the Company, Interest on Loans, Interest on Capital and Income Tax, but after making ample provision for bad debts, depreciation of Plant, Machinery, Fixtures, etc.

We also certify that the new Fixtures and Fittings, which have been added to the Market-place premises since the rebuilding in 1900, after the fire, have cost the vendors £11,177.

Referring to the proposed issue of £100,000 $4\frac{1}{2}$ per Cent. Debenture Stock, we, the Auditors of Messrs..... and Co., certify that the profits of their business, after writing off all expenses and making ample provision for wear and tear and depreciation, and also for Income Tax, amounted (inclusive of interest on capital) to upwards of £22,500 in each of the four years from 1st April, 1899, to 31st March, 1903, being in each year more than five times the sum required to pay the interest on the proposed Debenture Stock.

You will observe how frequently the average profit was given without showing the results of individual periods, a practice which of course has been discontinued.

Report on Profits Now Compulsory

Just as it took such a long time for the legislature to make the audit of the accounts of limited companies, other than banks, compulsory—it was not until 1900, although before that time the appointment of auditors under a company's own Articles of Association was quite customary—

in the same way it has taken many more years before it became obligatory for prospectuses to contain a report on the profits. The following is the wording from Part II of the Fourth Schedule to the Companies Act, 1929, regarding reports to be set out in prospectuses:

1. A report by the auditors of the company with respect to the profits of the company in respect of each of the three financial years immediately preceding the issue of the prospectus and with respect to the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the said three years, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years, and, if no accounts have been made up in respect of any part of the period of three years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

2. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by Accountants who shall be named in the prospectus upon the profits of the business in respect of each of the three financial years immediately preceding the issue of the prospectus.

The accountants have a great responsibility in regard to their report, as they are responsible not only to the issuing house who, relying on the report, proceed with the flotation, but also to the public who probably subscribe for the shares or debentures on the strength of the certified figures. A great many important accountancy questions emerge from the adjustment of profits for prospectus purposes, but I need not go into these in detail. The report should be concise and should deal with facts only—the accountants should not attempt to make estimates or certify them or express any opinion as to the future. The period of years to be dealt with in the report is of great importance from the point of view of showing the trend, and although the Act mentions a period of three years only, if the accountants consider that such a period is not sufficient to give an adequate picture of the real earning capacity of the concern, they should select a sufficiently long period of years so as to enable the effects of any abnormal prosperity or depression to be properly appreciated. The accountants should clearly indicate in their report the manner in which

the profits have been adjusted so as to arrive at the figures quoted, which, as far as circumstances permit, should be the balance remaining after all charges have been allowed for, available for interest or dividend on the debentures or shares offered, and reserves.

Recent Accountants' Reports

As a contrast to the certificates of profits I have already quoted, I would like to give you the following Accountants' Reports which have been taken from some recent prospectuses:

We have examined the books and audited accounts of.....
....., Limited (formerly Co., Limited), for
the period from 11th March, 1931 (date of incorporation of the
Company) to 27th September, 1936, and we report that the
profits (or losses) have been:

Period from 11th March, 1931, to 1st October,	
1932	Loss £5,079
Year ended 1st October, 1933	Loss 224
Year ended 30th September, 1934	Profit 8,838
Year ended 29th September, 1935	Profit 17,167
Year ended 27th September, 1936	Profit 28,978

These results are arrived at before charging Income Tax and Interest on Bank Overdraft, but after charging depreciation of Fixed Assets based on the valuation by Messrs..... & Co., dated 1st December, 1936, and calculated at the rates recommended by them and after making such adjustments as we consider appropriate, including the revision in each period of the remuneration of Directors and Managers to the amounts payable under Agreements with your Company.

The following is a statement of the Net Assets acquired by your Company based as regards Fixed Assets on the valuation by Messrs. & Co., dated 1st December, 1936, and as regards the other Assets and Liabilities on the audited Balance Sheet of the Vendor Company as at 27th September, 1936, after making appropriate adjustments including provision for taxation and a dividend subsequently declared:

FIXED ASSETS:	£	£
Freehold Land and Buildings	77,000	
Plant and Machinery, Loose Tools and Utensils, Moulds, Motor Cars, etc.	37,635	
		114,635

THE CANADIAN CHARTERED ACCOUNTANT

FLOATING ASSETS:

Stock of Manufactured Goods, etc. . .	35,956	
Contracts-in-Progress less Payments received on account	6,046	
Debtors, less Reserves, Deposits and Payments in Advance	39,193	
Cash in hand	61	
		81,256
		<hr/> 195,891

Deduct:

CURRENT LIABILITIES:

Creditors and Accrued charges	36,271	
Bank Overdraft	2,904	
Provision for Income Tax to 27th Sep- tember, 1936	6,660	
Provision for Dividend (less Income Tax) on Issued Share Capital of Vendor Company in respect of period to 27th September, 1936, since declared	2,942	
Expenditure on Fixed Assets between 27th September, 1936, (date of Bal- ance Sheet), and 1st December, 1936 (date of valuation)	11,368	
		60,145
NET ASSETS acquired		<hr/> 135,746

Add:

Proceeds of issue of:

35,000 Redeemable Cumulative Pref- erence Shares of £1 each at par ..	35,000
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TOTAL NET ASSETS (exclusive of Goodwill)	<hr/> £170,746
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We have examined the Books and Audited Accounts of A.B. and Co., Limited (the old company), and of the C.D. Company, Limited, for the five years ended 30th September, 1936, and we report that the profits have been:

PROSPECTUSES OF PUBLIC COMPANIES—BEHIND THE SCENES

	A.B. and Co., Ltd.	The C.D. Co., Ltd.	TOTAL
	£	£	£
Year ended 30th September, 1932 ..	138,292	16,380	154,672
Year ended 30th September, 1933 ..	125,430	16,265	141,695
Year ended 30th September, 1934 ..	132,118	17,579	149,697
Year ended 30th September, 1935 ..	137,159	18,615	155,774
Year ended 30th September, 1936 ..	132,435	19,936	152,371

These profits which are exclusive of premiums received in respect of Leases granted to Tenants, are arrived at after charging repairs and upkeep of Licensed Properties and after making such adjustments as we consider appropriate, including the revision in each year of the remuneration of Directors to the amounts payable under arrangements with your Company, but before charging Interest on Loans (to be repaid), Depreciation (referred to below) of Plant and Machinery, Motor Vehicles and Freehold Properties and amortisation of Leasehold Properties and Income Tax.

The Profits of the C.D. Company, Limited, stated above comprise only such profits as are derived from the Assets acquired by your Company.

Depreciation of Plant and Machinery, Motor Vehicles and Freehold Properties and amortisation of Leasehold Properties based on the valuation by Messrs.....dated 27th February, 1937, and calculated at the rates recommended by them would amount to £16,280 per annum.

The following is a statement of the Net Assets acquired by your Company based, as regards Fixed Assets on the valuation, dated 27th February, 1937, by Messrs.....and as regards other Assets and Liabilities on the Balance Sheet of A.B. and Company, Limited (the old company), dated 30th September, 1936, adjusted in respect of taxation and dividends subsequently declared and, in the case of Mortgages and Loans to Tenants acquired from the C.D. Company, Limited, at the amount of the consideration payable therefor:

FIXED ASSETS:	£	£
Freehold Properties	490,905	
Leasehold Properties	92,060	
Freehold Brewery, Land, Wine and Spirit Stores, Garages and Cottages	101,000	
Fixed and Loose Plant and Machinery, Motor Vehicles, etc.	69,245	
		753,210

THE CANADIAN CHARTERED ACCOUNTANT

FLOATING ASSETS:

Stock-in-Trade, Bottles and Cases, Casks, etc., as certified by Managing Director	66,490	
Debtors (less Reserve) and Payments in Advance	68,828	
Mortgages and Loans to Tenants	42,825	
Cash at Bankers and in hand	15,800	
		<hr/>
		193,943
 Deduct:		<hr/>
		947,153

CURRENT LIABILITIES:

Creditors and accrued charges	62,172	
Provision for Income Tax	15,366	
Loans	50,000	
Provision for Dividends declared since 30th September, 1936	76,097	
Expenditure between 30th September, 1936 (date of Balance Sheet), and 27th February, 1937 (date of valu- ation), on Fixed Assets	13,513	
Shares in Subsidiary Company	50	
		<hr/>
		217,198
 NET ASSETS ACQUIRED		<hr/>
		729,955

Add:

Net Proceeds of £400,000 4 per cent. Redeemable Debenture Stock after deducting cash portion of purchase consideration for the assets of the C.D. Company, Limited, and estim- ated Preliminary Expenses		135,000
		<hr/>

TOTAL NET ASSETS (exclusive of Goodwill)	<hr/>	£864,955
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We have examined the books and audited accounts of the Company, Limited, for the three financial years ended 31st December, 1936 (during which period the business was conducted under that Company's former name of..... Limited). We report that the profits, arrived at on the basis mentioned below, were as follows:

PROSPECTUSES OF PUBLIC COMPANIES—BEHIND THE SCENES

	£
Year ended 31st December, 1934	213,302
Year ended 31st December, 1935	291,626
Year ended 31st December, 1936	321,897

The above profits have been arrived at after charging all working expenses and after making such adjustments as in our opinion are appropriate, including the revision of the charges for depreciation and for directors' remuneration to the remuneration payable in future on the basis of the new agreements entered into by your Company, but before charging Income Tax and interest on Bank and other loans proposed to be repaid.

The working expenses charged in arriving at the above profits include in each year a proportion of certain expenses incurred by the.....Company of the United States of America, which expenses were, we understand, apportioned between that company and its associated companies, according to a formula based on the sales of the respective companies of the.....Group.

We have examined the books and accounts of the.....Company, Limited, for the five years ended 31st December, 1936, and report that the profits were as set out below:

<i>Year ended 31st December.</i>	<i>Profits. £</i>
1932	9,225
1933	12,975
1934	26,014
1935	24,385
1936	30,513

These profits are stated after charging all expenses of working and management, including Directors' remuneration at the rates agreed to be paid in future and depreciation on the basis of the valuation of the fixed assets by Messrs.....as on the 31st December, 1936, and after making such other adjustments as we have considered to be appropriate, but before deducting Income Tax.

We further report that the net assets of the Company as at 31st December, 1936, on the basis of the Balance Sheet at that date after providing for the final dividend subsequently declared on the Ordinary Share Capital, were as set out below:

THE CANADIAN CHARTERED ACCOUNTANT

FIXED ASSETS:

As valued by Messrs..... as on the 31st December, 1936:	£	£	£
Freehold Land and Buildings	37,225		
Plant, Machinery, Tools, Dies, Fur- niture, Equipment and Motor Vehicles	38,029		

CURRENT ASSETS:

Stocks of Raw Materials and Manufac- tured Goods, as valued by Messrs. & Sons	27,814	
Trade Debtors and Expenses Prepaid, less Reserves	48,515	
Cash at Bank and in hand	16,575	
	<hr/>	92,904

Deduct Current Liabilities:

Trade Creditors, Provisions for Accru- ing Expenses and Income Tax	37,892	
Final Dividend, less Tax, subsequently declared on the Ordinary Shares ..	14,863	
	<hr/>	52,755

Excess of Current Assets over Liabil- ities	<hr/>	40,149
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TOTAL NET ASSETS, excluding GOODWILL	<hr/>	£115,403
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Formation of New Company

If you have studied many prospectuses at all carefully you will doubtless have observed that when an existing business is floated as a public company, even if it has previously been carried on by a private company, it is the almost invariable practice to form a new company to take over the business from the old company. You may have wondered why this is done, as it seems at first sight to be an unnecessary extravagance, seeing that the stamp duty on the capital of the old company as well as all the other expenses attendant on its formation are lost.

There may be various reasons for forming a new company. For example, there may be debentures which can only be got rid of by liquidation, or contracts which it is

desired to terminate. Another and perhaps not quite so evident reason arises in this way:

When a successful business has been operated privately it will often be found that the assets have been well written down and that in addition there is a valuable goodwill for which nothing appears in the balance sheet. Hence the shareholders in the old business are only willing to sell their holdings at a substantial premium. If it were desired to go to the public without forming a new company, it would consequently be necessary either to offer the shares to the public for sale at an equivalent premium or else to write up the share capital to its true value. The former course is usually impracticable as the public do not always look with favour on a highly priced share even when the yield is satisfactory. The alternative course of writing up the share capital is also considered inadvisable as it would involve writing up the assets, possibly creating a figure for goodwill where previously none existed, and then issuing bonus shares. While this procedure may seem all right in theory, doubts have been thrown upon its legality, and consequently it is customary to form a new company to acquire the assets of the old one at the increased values.

A draft contract between the new company and the old company for the purchase and sale of the undertaking and assets of the latter will probably now have been drawn up. This should be also submitted to the accountants, who should see that the question of how certain liabilities should be treated has been properly dealt with. I refer particularly to income tax and sur tax. If the new company takes over the business of the old company as from a past date, it seems only right that the new company should bear its proper proportion of income tax on such profits, notwithstanding the fact that the Inland Revenue Authorities will assess the old company on the profits right down to the date of the contract for sale. As the Inland Revenue has the right to reopen the previous year's assessment on the old company going into liquidation, the accountants should consider the effect on the income tax position and make the necessary adjustment in the liability. What the new company is intended to take over in the way of liabilities should, of course, be clearly stated in the sale agreement. Some difficulties may arise in connection with sur tax. Frequently this question is not dealt with in the sale agree-

ment and disputes have arisen as to the liabilities of the old company and as to whether they included sur tax. If the old company is a company to which the sur tax provisions of the various Finance Acts apply, the accountants should consider the effect of the old company going into liquidation and see that the sale agreement specifically deals with the question as to who is to bear the sur tax, if any, on the profits right down to the date of liquidation.

Change to a Public Company

At the commencement of my paper I said that the owners of a business may possibly for taxation reasons have decided to realize some of their interests, and you may have wondered what special considerations I had in mind. You will have noticed that during the past two or three years a great many small businesses showing profits of, say, about £20,000 per annum have been floated on the market, and I think the crushing burden of taxation is partly the reason for this. While the businesses are run as partnerships or as small private limited companies, they feel the full force of income tax and sur tax. These businesses in the past may have been built up out of profits and the owners may have been content with modest distributions, but nowadays if profits are retained in the business for further expansion, after meeting income tax and sur tax there is very little left to distribute. There is thus under present taxation conditions no incentive to expand the business by retaining profits. But by floating the business as a public company the owner can avoid sur tax on the profits kept back for development; he can usually get some of his purchase consideration in cash which he can invest, the company can obtain further working capital and the owner's net income can be improved notwithstanding the fact that he has possibly disposed of a considerable part of the equity of his business. It is a nice point for you to consider and clients who may be contemplating floating their businesses as public companies will be somewhat intrigued if you put these suggestions before them.

Statement of Net Assets

If the accountants have been asked to include in their report a statement of the net assets of the vendor concern, they will now be able to complete their report after having

perused the purchase and sale agreement. This statement will be based on the balance sheet as at a past date, and in the event of capital expenditure having taken place between the date of the balance sheet and the date of valuation of the fixed assets, the accountants should make the appropriate adjustment. The accountants may also be required to include in their statement of net assets the additional cash resulting from the issue after payment of the cash portion of the purchase consideration, the underwriting commission and the estimated preliminary expenses. The amount of the last two items will, of course, be obtainable from the draft of the prospectus. Incidentally, amended proofs of the prospectus will by this time be coming in. There will be discussions with the advertising agents as to the newspapers in which the prospectus should be advertised, in full in some newspapers, in abbreviated form in others, the estimate of the cost, and so on. These various proofs require unremitting attention on the part of the accountants, although it may be somewhat irksome to have to go through the prospectus time and again for the sake of some slight alteration or set up. After the prospectus has been submitted to and approved by the Stock Exchange, we finally come to the last proof usually called the "Underwriting Proof" for submission to the underwriters.

Last stage of all is the meeting with the various parties at which contracts are signed and exchanged and the prospectus signed by all the directors. After completion, these contracts should be examined by the accountants and checked carefully with the information given in the prospectus under the heading of contracts, and having satisfied themselves thereon they can now hand over their report in its final form. At the same time the auditors to the new company can submit their report pursuant to Schedule IV of the Companies Act. This is a purely formal report, but the auditors should see the certificate of incorporation of the company and satisfy themselves as to the capital paid up in the new company.

The issuing house now make arrangements as to the day on which the prospectus is to be advertised, being advised by the newspapers as to whether other prospectuses are also being advertised on the same day so as to avoid any clashing.

Critical Analysis of Prospectus

And now the work of the accountants being finished, they will look forward to the publication of the prospectus, the criticisms in the press and the result of the issue. But what of the critics? How best should a prospectus be criticized? I think in the following manner:

From what "stable" is the Issue being made? In other words, what is the reputation of the issuing house sponsoring the issue?

What is the standing of the directors and to what other companies do they act as directors?

What is the reputation of the solicitors, stockbrokers, auditors, accountants to the issue (if any) and valuers?

Is the business a new one or old-established? If the former and estimates of future profits are given in the prospectus, who has made these estimates, and do they appear reasonable? If it is an established business, does the Statement of Profits show much variation year by year, and does the prospectus state the reason for the varying trend? It is a truism that an investor in a new enterprise is taking more risk than if he were investing in a concern with a good past history.

Does it appear that adequate working capital has been provided for?

To what extent do the assets include goodwill, or is the capital fully covered by tangible assets?

Are the vendors taking a substantial part of the purchase consideration on sale of the business in shares and to what extent?

Are the arrangements for the future management of the company apparently satisfactory?

Are the expenses incidental to the issue reasonable, and who is to bear them?

What do the promotion profits amount to?

What are the rights of the various classes of capital as to voting, as to dividends, and as to capital in a winding up?

What is the security of the various classes of debentures and shares as regards income and capital? In other words, how many times are the dividends covered by profits and the capital by tangible assets?

And whatever the result of the issue and whether or no the accountants to the issue are also the auditors to the new company, I am sure they will always take a lively interest in the future of the company they helped to bring into being.

SOME DIFFICULTIES OF EXPORT TRADE*

By Walter Lattman, Toronto, Ontario

EXPORT trade is important for Canada because the excess commodities produced over our domestic requirements usually is about one-third of the national production.

Canada ought then to push foreign trade. Good work is being done by our Department of Trade and Commerce through Trade Commissioners, but it is difficult to see how all the barriers to foreign trade can be removed or lessened. Artificial elements have overbalanced natural forces, and there are multifarious devices in several countries to bring business under rigid authoritarian control. But if international trade is to be restored in an effort to stimulate consumption all around, the various countries of the world have to be linked again in a freer exchange of their products.

Any business has its difficulties and problems; this is true of selling home-made cakes at the front door, or groceries all over the Dominion. It is a matter of degree and volume. The same applies to the difficulties and problems of export business; they are different for different trades and for different types of business. Shirts, or radios, or motor cars, are the same in Canada or Brazil or Europe (though in Brazil the electric horn may not be used and in the Argentine they drive on the left side of the road). A Canadian plow, however, cannot be sold in Brazil; they require a special one suited to their soil.

Then again there is the method. You can sell your wares to a merchandising house in Montreal or New York and leave it to them to bridge the difficulties, if there are any, or you may go to the foreign market yourself. It is very much the same as going into a new territory at home—for example, from Ontario to Quebec—for the same basic difficulties or problems are there. The reason why a problem becomes a difficulty is that often so many things are magnified because they appear unusual. Unknown things, which are full of appeal to the adventurer, create feelings of fear for the uninitiated.

*Summary of an address given to the Toronto members of the Canadian Society of Cost Accountants and Industrial Engineers on 22nd February last.

Some Peculiarities of Export Business

Export difficulties at once suggest to our minds tariffs, quotas, and exchange regulations; but there are also difficulties regarding quality, design, packing, ocean freight, insurance, etc. The methods of selling, advertising and servicing must be given attention. A good business man in Ontario would not start a venture in Quebec without finding out about that market. He would want to know what they buy, and through whom, what their laws are and what taxes on business are in effect. He would probably require somebody in the office who could write and speak the French language.

Of course, at home, there are so many matters or circumstances one takes for granted because one has grown up with them, e.g. seasonal trends, national custom, psychological reactions, the almost subconscious reaction to existing laws and rules, relative values, etc.

Abroad you have to learn all this. You find that other countries do strange things which to you may appear unreasonable, difficult to understand, and sometimes even objectionable. But they have done these things for longer periods than your own people do other things, and they are satisfied with them. So you acquaint yourself with language, law, climate, diseases of the humans, insects which destroy wood and fabrics, tastes, buying habits, etc. As an illustration of differences in buying habits, in Canada paint is sold at hardware stores. The hardware dealer in France seldom has paint; that is the business of the "marchand de peinture" who sells kerosene and turpentine, mops, brushes and floor wax—but candles are sold by the tobacco vendor. A well-known American soap manufacturer found some very interesting things about the preparation of toilet soap for the import markets. In one country it was sold by the barbers; in another, by the grocers. In one, they buy it wrapped individually; while in others, they want six or twelve cakes in a box. A raincoat manufacturer could not understand why the Canadian Trade Commissioner could not find a firm in Lima, Peru, to take his agencies. He was told the last rain fell nineteen years ago.

All this has always been the *peculiar side* of export business; the salesmen or engineers or chemists have learned all about these things, even about foreign weights and measurements and moneys.

As far as individual firms are concerned, the stepping over national boundaries and thereby engaging in export trade, is practically always a matter of selfish considerations—cost reduction by spreading overhead, for instance. From a national point of view, however, export trade fulfils the eminently important function of providing the means for our purchases abroad.

It is chiefly this public aspect of export business which has created its greatest problems, and which has required a new type of study. It is a study which does not come under the headings of manufacture, sales, collections and administration, and it is not always a natural extension of the experience accumulated in these divisions of a business. This may be a reason why so little is said in the schools of commerce and business colleges or in the current literature concerning business in general. But I submit that there are many aspects of export business which profoundly affect domestic business. And another important point with these factors, business steps outside its own sphere. It has to ask for government interference, because only governments can talk with other governments. Tariffs, quotas and exchange regulations are made by other governments.

Every country depends upon imports of some kind. Autarchy, or efforts to attain self-sufficiency can reduce imports, but the price is paid somewhere all the same. The only honest way to get rubber, cotton, tin, tea or any of the things that the home soil does not produce, is to pay for them, or in other words, exchange home products or services or gold for foreign produce.

Trade Now Two-Cornered

As long as trade was practically free it did not matter whether Canada bought from France and sold to Germany because France accepted German marks in payment for our purchases, and as in a clearing house, the sums of money actually flowing from one country to another were insignificant in relation to the total trade involved. These were the times when trade was *multi-cornered*, as the term is used. But with the use of exchange control, quotas, etc., trade was reduced to barter. This two-cornered arrangement has indeed become a pretty narrow affair and Italy affords a good example for our purposes. Here is a country

that had practically no supply of industrial raw materials. But a reasonably prosperous world bought its wines, cheese and antiques; crowds of tourists annually visited its many places of historic interest, and numerous emigrants from a crowded peninsula to South America sent considerable money home. There was then, a certain balance between Italy's purchases from abroad and its exports in goods, sight-seeing and the remittances that came in from abroad. That balance is one of the many that the war disrupted. The facts are that war brought heavy burdens, one of which was a partly disrupted economy. Tourist trade was lacking. Wines and cheese were not bought as freely by outsiders, and the emigrants, experiencing harder times themselves, sent less money home, and in many cases, could not because of exchange restrictions in the countries where they lived.

The trade balance of Italy had always been passive, but the deficit was balanced by incoming money from tourists and Italian emigrants abroad. Now the *payment* balance became passive and the difference had to be made up by gold exports. But depletion of gold reserves meant financial disaster. The government had to step in to balance imports and exports. As exports met increased obstacles, such as import or exchange restrictions in other countries, the only method of balancing was the restriction of imports. Quotas were established, and when this method became insufficient, exchange control was instituted. This means, in addition to import restriction, the redirecting of imports by favouring countries which import Italian goods.

This system of exchange control requires numerous forms to be filled in and extraordinary procedure to be followed, and in dealing with such countries as Italy and Germany, the exporter has to carry on negotiations with compensation offices both before and after the sale of goods and has often to wait weeks for his money.

Trade agreements, then, are in effect with a country's chief customers on the basis of making exports pay for imports. Even a prosperous country like Denmark has had to institute exchange control. The two largest customers for Danish products are Great Britain and Germany and, therefore, the bulk of import permits is for goods from these countries. It becomes all very complicated and costly, and international trade has to pay for all this additional expense.

INCOME TAXES, SUCCESSION DUTIES AND OTHER DIRECT TAXES IN CANADA, THE UNITED STATES AND GREAT BRITAIN NOT INCLUDING TAXES ON PROPERTY*

By Walter L. Gordon, Chartered Accountant,
Toronto

BEFORE commencing to discuss the taxes which are the subject of this paper, it seems desirable to review briefly the different sources of tax revenue in Canada, the United States and Great Britain in order that the particular taxes under discussion may be seen in proper perspective.

TABLE 1 — Revenues from Taxation in Canada¹

(Note—Both the Dominion and the Provincial Governments' revenues from taxation were considerably higher in 1936 and 1937 than in previous years.)

	Year ended 31st March 1936
<i>Dominion Government²</i>	
Income taxes	\$ 82,709,803
Customs duties	74,004,560
Sales tax	77,551,974
Tax on cheques, transportation tax, etc.	35,181,074
Excise taxes	44,409,797
Miscellaneous taxes	3,454,601
Total tax revenue of the Dominion Government ..	\$317,311,809
<i>Provincial Governments³</i>	
Succession duties	\$ 18,290,161
Income, etc. ⁴	9,227,220
Corporations ⁵	19,182,560
Gasoline	31,715,374
Automobile licenses	21,178,181

*One of a series of papers presented to a Toronto group who are studying the systems of taxation in Canada, the United States and Great Britain. Indirect taxes and taxes on property were covered in other papers.

¹These figures do not include government revenues other than taxation—such other revenues would amount to a considerable total.

²Figures obtained from the Dominion Bureau of Statistics.

³Figures obtained from the Citizens Research Institute of Canada—Fiscal years of the provinces end on various dates; the years chosen are those having the most months in the calendar year 1935.

⁴This is nearly all income taxes, but includes a small amount of personal property and poll taxes.

⁵This includes the taxes on corporations' profits levied under the Corporation Tax Acts of the Provinces.

THE CANADIAN CHARTERED ACCOUNTANT

Real property ⁶	4,903,668
Amusements	3,777,667
Miscellaneous	1,763,965

Total tax revenues of the Provincial governments	<u>\$110,038,796</u>
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Municipal Governments³

Total tax revenues of Municipal governments from real property, business and income taxes ⁷	<u>\$262,062,513</u>
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Grand total	<u>\$689,413,118</u>
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The sources of the tax revenues of the various governments in Canada shown in the above table compare as follows with those of Great Britain and the United States:

TABLE 2 — Summary of Total Revenues from Taxation in Canada, the United States and Great Britain — in Millions of Dollars

	Canada ⁸	United States ⁹	Great Britain ¹⁰
Real property	\$244	\$ 4,500	\$ 830 ¹²
Income taxes	115 ¹¹	2,600	1,554
Corporations	19		
Estate duties	18	400	440

⁶This includes property taxes in British Columbia on territories which are not organized as municipalities and real property taxes levied by the other Western Provinces.

⁷The figure of \$262,062,513 is approximate only. In addition to real property taxes it includes income and business taxes amounting to approximately \$12,000,000 in Ontario, \$8,000,000 in Quebec and \$3,000,000 in the other provinces (an approximate total of \$23,000,000). This will be reduced in future as the Province of Ontario has taken over the income tax from the Ontario municipalities.

⁸The Canadian figures for the most part are for the year 1935.

⁹The United States figures were obtained from "Facing the Tax Problem" prepared by the Twentieth Century Fund Inc. and are for the twelve months ending 30th June 1937.

¹⁰The figures for Great Britain (with the exception of the item of \$830,000,000 referred to in note #5) are for the year ended 5th April 1937 and were obtained from the Financial Statement of the Chancellor of the Exchequer. All conversions have been made at the rate of \$5 to the pound sterling.

¹¹Includes \$23,000,000 income and business taxes collected by the municipalities; does not include taxes on corporations' profits levied under the Corporation Tax Acts of the provinces.

¹²This represents the total receipts from rates of the local authorities or municipalities. The figures were obtained from the Statistical Abstract for the United Kingdom and are for the year 1932-1933 (with the exception of the receipts of the local authorities in Scotland, which are for the previous year).

INCOME TAX SUCCESSION DUTIES

Gasoline tax and automobile licenses	53	1,100	27 ¹³
Sales tax	78	400	
Excise taxes	44	1,400	548
Payroll tax		400	
Customs duties	74	400	1,056
Miscellaneous	44	1,300	154
Total	<u>\$689</u>	<u>\$12,500</u>	<u>\$ 4,609</u>

The relative importance of the different taxes shown in Table 2 are shown in the form of percentages as follows:

TABLE 3 — Relative Importance of the Different Taxes Levied in Canada, the United States and Great Britain — in Percentages

	Canada	United States	Great Britain
Real property	35.4%	36.0%	18.1%
Income taxes	16.7	20.8	33.8
Corporations	2.8		
Estate duties	2.6	3.2	9.6
Gasoline tax and automobile tax ..	7.7	8.8	.1
Sales tax	11.3	3.2	
Excise taxes	6.4	11.2	11.9
Payroll tax		3.2	
Customs duties	10.7	3.2	23.1
Miscellaneous	6.4	10.4	3.4
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

In Canada and the United States taxes on real estate are by far the greatest source of government tax revenues. Income taxes are next, being 16.7% of the total in Canada and 20.8% in the United States. (The percentage for Canada would be higher if the provincial taxes on corporation incomes were included). In Great Britain receipts from income taxes are the greatest source of revenue and represent 33.8% of the total; customs revenues are second and represent 23.1%. Succession duty receipts in Canada represented 2.6% of the total tax receipts in 1935; estate taxes amounted to 3.2% of the total in the United States and to 9.6% in Great Britain.

¹³This represents the Exchequer's share of motor vehicle duties.

Income Taxes

The revenues derived by governments from taxes on income are summarized in the following table:

TABLE 4 — Analysis of the Receipts from Taxes on Income — in Thousands of Dollars

	Federal	State	Municipal	Total
Canada ¹⁴	\$ 82,710	\$ 9,227	\$23,000	\$ 114,937
United States ¹⁵ ..	2,300,000	300,000		2,600,000
Great Britain ¹⁶ ..	1,554,000			1,554,000
	in percentages			
Canada	71.9%	8.1%	20.0%	100%
United States ...	88.5%	11.5%		100%
Great Britain ...	100 %			100%

In Canada and the United States the Federal governments collect by far the largest share of all income taxes. In Great Britain the Exchequer collects all income taxes.

FEDERAL INCOME TAXES ON CORPORATIONS

In Canada and the United States a substantial part of the income tax collections by the Federal governments is represented by taxes on corporations. This is shown by the following table:

TABLE 5 — Analysis of Income Tax Collections by the Federal Governments of Canada and the United States between Corporations and Individuals

	Canada ¹⁷		United States ¹⁸
	Year ended 31st March 1926	Year ended 31st March 1936	Year ended 30th June 1936
Corporations	\$31,723,000	\$32,983,000	\$ 739,000,000
Individuals	23,849,000	42,519,000	674,000,000
5% tax on dividends and interest payable to non-residents		7,208,000	
Total	<u>\$55,572,000</u>	<u>\$82,710,000</u>	<u>\$1,413,000,000</u>

¹⁴The Canadian figures for the most part are for the year 1935.

¹⁵The United States figures are for the twelve months ended 30th June 1937.

¹⁶The figures for Great Britain are for the year ended 5th April 1937.

¹⁷Figures obtained from the Dominion Bureau of Statistics.

¹⁸Figures obtained from "Facing the Tax Problem" by the Twentieth Century Fund Inc.

In Canada, corporations pay a Federal income tax of 15% of their taxable net profits; in computing the taxable net profits deductions may be made for any dividends received from other Canadian companies. There are no surtaxes or other taxes on corporation incomes levied by the Federal authorities in Canada. Taxes on the income and capital of corporations which are levied by the Provincial Governments (and which are relatively less important) will be reviewed in a later section.

Corporations in the United States pay a "normal" tax on their profits and a surtax on undistributed profits. The normal tax is 8% on the first \$2,000 of taxable income, 11% on the next \$13,000, 13% on the next \$25,000 and 15% on all taxable income in excess of \$40,000. In computing the net income subject to normal tax, deductions may be made to the extent of 85% of any dividends received from other United States companies.

The full amount of all dividends received must be included, however, in computing the "adjusted net income," the undistributed portion of which is subject to the undistributed profits tax. Deductions may be made in the latter case for interest earned on certain United States Government bonds and for the amount of the normal tax. The "undistributed adjusted net income" is found by next deducting the dividends paid. The balance is subject to a surtax at 7% of the first ten per cent. of adjusted net income; at 12% of the next ten per cent.; at 17% of the next twenty per cent.; at 22% of the next twenty per cent.; and at 27% of the remaining forty per cent. If no dividends were paid out the average rate would be 20.5%. (If a corporation's adjusted net income is less than \$50,000, the first surtax rate of 7% is applied to the first \$5,000, thus reducing the top bracket on which the rate may be 12%, 17% or 22% as the case may be).

In addition to the taxes on income described in the preceding paragraph, the United States Federal Government levies a capital stock tax on corporations and an excess profits tax. The capital stock tax is at the rate of \$1 per \$1,000 based upon the declared value of the stock of the corporation. The value declared is determined by the taxpayer and need not necessarily reflect the actual value of the stock of the corporation. The capital stock tax is levied each year by adding to the original declared value the income of

the corporation plus further additions to its capital less dividends and distributions to shareholders and losses. An amount of income equal to 10% of the adjusted declared value for capital stock tax purposes is exempted from excess profits tax. Income in excess of 10% of the declared value or adjusted declared value and not in excess of 15% is subject to a tax of 6%; and the income in excess of 15% of the adjusted declared value is subject to an excess profits tax of 12%. In addition to the Federal taxes referred to, corporations in the United States are subject to income and other taxes levied in some of the States.

In Great Britain corporations pay a tax on profits at the standard rate which for the current year ending 5th April 1938 is five shillings in the pound or 25%; corporations in Great Britain (other than small privately held companies) do not pay the surtax levied on individuals in that country which will be referred to later. While the rate appears high in Great Britain, this is offset by the fact that corporations in that country may deduct from all dividends and interest paid the amount of the tax at the standard rate for the year. In other words, while British companies pay a high tax on their profits at the time such profits are made, they get it back on any part of the profits that are paid out in dividends or interest. Thus only one tax is paid on the profits earned by corporations in Great Britain. In Canada and the United States corporations pay a tax on their profits (15% in Canada and up to 15% in the United States) and their shareholders pay a second tax on that part of the profits which they receive in the form of dividends.

Another major difference in the basis for taxing corporations and also individuals in the three countries is that in the United States "capital gains" are included as taxable income. Capital losses are deductible only to the extent of capital gains plus \$2,000. Capital gains or losses are the profits or losses realized on the sale of any asset which is not ordinarily included as part of the inventory for sale. In the case of an individual 100% of the gain or loss is taken into account in computing net income if the capital asset has been held for not more than one year. The percentage gradually diminishes to 30% if the capital asset has not been held for more than ten years. (Corporations get no similar benefit for a holding period). Both corporations

INCOME TAX SUCCESSION DUTIES

and individuals are subject to the \$2,000 maximum capital loss limitation. Capital gains and losses are not taken into account in arriving at the taxable income of corporations or individuals in either Canada or Great Britain.

The following comparison is presented in order to indicate by an exaggerated example the application of the Federal income taxes on corporations in Canada, the United States and Great Britain:

Trading profit of corporation X	\$200,000
Dividends received from corporation Y	50,000
	<u>\$250,000</u>
Profit realized on sale of building	100,000
	<u>\$350,000</u>
Less loss incurred on sale of machinery	25,000
	<u>\$325,000</u>
Dividends paid	150,000
Net addition to surplus account	<u>\$175,000</u>

1. Tax payable in Canada:

Net profit	\$250,000
Less dividends received from corporation Y	50,000
Taxable income	<u>\$200,000</u>
Tax at 15%	<u>\$30,000.00</u>

2. Tax payable in the United States:

Net profit	\$250,000
Capital gains less capital losses	75,000
	<u>\$325,000</u>
Less 85% of dividends received from corporation Y	42,500
Net income subject to normal tax	<u>282,500</u>
Normal tax at 8%, 11%, 13% and 15%	41,215.00
Undistributed adjusted net income subject to undistributed profits' tax (\$325,000 less \$150,000 and \$41,215) ..	<u>\$133,785</u>
Undistributed profits' tax (20.5%) ..	<u>27,425.93</u>
Total not including capital stock tax or excess profits' tax	<u>\$68,640.93</u>

3. Tax payable in Great Britain:

It will be apparent from the above example that the taxes levied on the profits of corporations in the United States may be considerably heavier than in Canada or Great Britain.

In Canada the Dominion Government levies a general income tax on individuals which is based on a graduated scale of rates of from 3% on the first \$1,000 of taxable income to a maximum of 56% on that part of the total income which is in excess of \$500,000. In addition all "investment income" (which includes all unearned income and all income in excess of \$14,000) is subject to a surtax based on a sliding scale beginning at 2% up to a maximum of 10% on that part of the total income which is in excess of \$200,000. An amount of 5% is added to both the above taxes. Personal exemptions or allowances in Canada include:

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In computing the net income liable to the surtax on "investment income" the following deductions may be made:

1. \$5,000 or
2. "Earned income" up to but not exceeding \$14,000 or
3. The total allowances for a single or married man and dependents referred to above.

Income taxes payable to the United States' Federal Government include a normal tax of 4% of net income plus a surtax which is based on a sliding scale of from 4% on "surtax net income" in excess of \$5,000 and not in excess of \$6,000 up to 75% of "surtax net income" in excess of \$5,000,000. Exemptions and deductions allowed in computing both the normal tax and surtax are:

1. Personal exemption—single\$1,000
married 2,500
2. Dependents under eighteen years \$400 each.

Deductions which may be made in computing income subject to normal tax (but not applicable when computing "surtax net income") include:

1. Interest on United States Government obligations.
2. 10% of earned net income (maximum deduction under this heading is \$1,400).

As previously stated "capital gains" are included as taxable income in the United States and capital losses are allowed as deductions up to the amount of capital gains plus \$2,000.

Income taxes in Great Britain include a tax at the standard rate and a surtax. The standard rate for the year ending 5th April 1938 is five shillings in the pound or 25% (the rate is one shilling and eight pence in the pound on the first £135 of income after deducting allowances); the surtax is applicable on all incomes over £2,000 and is based on a sliding scale of from 5½% on the first £500 in excess of £2,000 to a maximum of 41¼% on all income in excess of £50,000.

In Great Britain the income of a wife living with her husband is added to his income and the total is included as the income of the husband for tax purposes.

The exemptions and allowances under the British Act are lower than in Canada and the United States. In Great Britain incomes which do not exceed £125 (\$625) are exempt from tax. Personal allowances or deductions include:

1. One-fifth of "earned" income up to a maximum of £300
2. Four-fifths of wife's "earned" income up to a maximum of £45
3. One-fifth of "unearned" income in the case of taxpayers over 65 years of age, provided the income does not exceed (or only slightly exceeds) £500
4. Personal allowance—single £100
married £180
5. Children £60 each—this includes adopted children
6. Housekeeper £50—this depends on whether the taxpayer is a widower (or widow) or single and/or the relationship of the housekeeper
7. Dependent relatives £25
8. Daughter's services £25 — in cases where the taxpayer is dependent on the services of a daughter resident with and maintained by the taxpayer
9. Life insurance premiums—if the policies were taken out after 22nd June 1916 relief or rebate is granted at two different rates as follows:
 - (a) Where income is taxed at only one shilling and sevenpence in the pound—relief or rebate of one shilling and sevenpence on the amount of the premiums.
 - (b) Where income is taxed at four shillings and ninepence in the pound—relief or rebate of two shillings fourpence halfpenny on the amount of the premiums.

The allowance is higher if the policies were taken out up to and including 22nd June 1916. These allowances are restricted as follows (each premium being considered separately):

- (a) To one-sixth of the total net income
- (b) Seven per cent. of the principal amount of the policy.

The above deductions are not allowable when computing surtaxes.

Insurance premiums are not allowed as deductions either in Canada or the United States. Another dissimilarity between the basis of taxing in Great Britain and Canada and the United States is that a taxpayer in Great Britain is assessed not only on his actual income but also on the estimated net income which he could obtain from property owned and occupied by himself. There is no such assessment for income tax purposes in Canada or the United States on owner-occupied property.

The fact that there is no double taxation on corporation earnings in Great Britain has already been commented upon.

Comparisons of the income taxes levied by the Federal governments alone in Canada, the United States and Great Britain would be incomplete unless the Provincial or State income taxes are also taken into account. Six of the nine provinces in Canada and thirty-four of the forty-eight States comprising the United States, levy income taxes; but the rates and bases of the taxes vary greatly. The Exchequer is the only taxing body in Great Britain which levies income taxes. In the comparisons which follow the total income taxes payable in Canada by a resident of Ontario and the total income taxes payable in the United States by a resident of New York State are compared with the income taxes levied in Great Britain. Comparisons are also given showing total income taxes payable by residents of Ontario and by residents of the other Canadian provinces.

The tax on income levied by the Province of Ontario is calculated on the net income after deducting the amount of the Dominion Government income tax. The sliding scale used in computing the Dominion general tax is applied to the balance and the result is divided by two to arrive at the Ontario tax. The fact that it is permissible to deduct the Dominion Government tax in arriving at the net income subject to the Ontario tax makes a great difference in the higher income brackets.

New York State income taxes (which may be deducted from gross income when computing net income subject to U.S. Federal income tax) run from 2% on the first \$1,000 of taxable net income to 7% on all taxable net income in excess of \$9,000. There is also an emergency tax of 1% of the taxable net income. No income tax is levied by New York City.

The following table shows the percentages of the total income taxes in 1937 to gross income in the Dominion of Canada (and Province of Ontario) the United States (and New York State) and Great Britain. The income taxes payable by a married man with no dependents and not entitled to any other exemptions or deductions have been used in this table and in the other comparisons given. This qualification must be appreciated when interpreting the comparisons.

TABLE 6 — Percentage of Income Taxes to Gross Income

Gross Income	Canada and Ontario	United States and New York State	Great Britain
\$ 5,000	3.65%	3.73%	18.25%
10,000	8.78	7.87	21.63
15,000	13.11	10.95	24.81
25,000	20.49	15.16	30.38
50,000	30.29	22.75	39.62
100,000	40.11	35.62	48.07
250,000	54.36	54.0	56.78
500,000	63.62	63.05	59.84
1,000,000	70.24	69.82	61.07
2,000,000	74.01	74.29	63.66
5,000,000	76.34	77.54	65.21

It will be seen that the taxes on the income brackets below \$250,000 are somewhat higher in Canada (Province of Ontario) than in the United States (New York State); above that figure they are approximately the same in both countries. It is also apparent that the taxes on the lower income brackets in Great Britain (particularly on incomes below \$15,000) are much larger than in Canada or the United States. On the other hand the taxes on incomes of \$500,000 and over are less in Great Britain than in the other two countries.

The difference in the ways in which taxable income is arrived at in the three countries makes an accurate comparison of the taxes applicable on the same amounts of income very difficult. In practice the percentage of the total tax on the higher income brackets in the United States may be relatively greater compared with the other two countries than the table indicates, if the taxpayer has made any "capital profits." It should also be remembered in studying the comparisons shown in the table that there is only one tax on the profits earned by corporations in Great Britain. In Canada and the United States corporations pay a tax on their profits and the shareholders pay another

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tax on the portion of the profits which they receive in the form of dividends.

No statistics are available to show the number of income tax payers in Great Britain by size of income and the amount of the taxes paid by each bracket. Such figures are available in respect to the collections by the Federal governments in Canada and the United States and are submitted herewith.

TABLE 7 — Analysis of the Number of Individual Income Taxpayers in Canada and the United States by Size of Income for the Calendar Year 1935, and Amount of Taxes Paid

Income	Canada ¹²		United States ¹³	
	Number	Amount	Number	Amount
Under \$5,000	175,492	\$ 4,204,731	3,992,627	\$ 44,763,000
\$5,000 to \$6,000	6,759	976,905	120,955	9,961,000
\$6,000 to \$7,000	4,267	948,545	81,348	9,730,000
\$7,000 to \$8,000	2,816	878,603	54,023	9,324,000
\$8,000 to \$9,000	1,898	834,797	38,029	9,175,000
\$9,000 to \$10,000	1,422	767,668	28,424	9,018,000
\$10,000 to \$15,000	3,303	3,033,935	74,541	40,857,000
\$15,000 to \$20,000	1,290	2,357,644	31,003	32,710,000
\$20,000 to \$25,000	654	2,029,986	16,351	28,690,000
\$25,000 to \$30,000	345	1,549,055	9,622	25,534,000
\$30,000 to \$40,000	373	2,556,873	10,519	44,313,000
\$40,000 to \$50,000	179	1,863,142	5,482	35,881,000
\$50,000 to \$100,000	304	11,055,666	7,878	110,557,000
\$100,000 to \$500,000			2,474	163,780,000
Over \$500,000			150	79,823,000
Total	199,102	\$33,057,550	4,473,426	\$654,116,000

(The above figures in percentages)

Income	Canada ¹²		United States ¹³	
	Number	Amount	Number	Amount
Under \$5,000	88.14%	12.72%	89.25%	6.84%
\$5,000 to \$6,000	3.39	2.95	2.70	1.52
\$6,000 to \$7,000	2.14	2.87	1.82	1.49
\$7,000 to \$8,000	1.41	2.66	1.21	1.43
\$8,000 to \$9,000	.96	2.52	.85	1.40
\$9,000 to \$10,000	.71	2.32	.63	1.38
\$10,000 to \$15,000	1.66	9.18	1.67	6.25
\$15,000 to \$20,000	.65	7.13	.69	5.00
\$20,000 to \$25,000	.33	6.15	.37	4.39
\$25,000 to \$30,000	.17	4.69	.21	3.90
\$30,000 to \$40,000	.19	7.73	.24	6.77
\$40,000 to \$50,000	.09	5.64	.12	5.49
\$50,000 to \$100,000	.16	33.44	.18	16.90
\$100,000 to \$500,000			.057	25.04
Over \$500,000			.003	12.20
Total	100%	100%	100%	100%

¹²Figures obtained from the Dominion Bureau of Statistics.

¹³Figures obtained from "Statistics of Income for 1935" issued by the U.S. Treasury Department, Bureau of Internal Revenue.

It will be seen that 88% of the taxpayers in Canada with incomes of under \$5,000 paid 12.72% of the total income taxes collected. 89% of the taxpayers in the same bracket paid 6.4% of the taxes in the United States. In 1935 there were 304 individuals in Canada with incomes in excess of \$50,000. These 304 people representing .16 of 1% of the total number of taxpayers paid taxes of \$11,000,000 or one-third of the total taxes collected. In the United States 10,502 individuals or .24 of 1% of the taxpayers had incomes in excess of \$50,000 and paid 54.14% of the total taxes collected.

The basis of the Ontario income tax has been briefly referred to. The Provinces of British Columbia, Alberta, Saskatchewan, Manitoba and Prince Edward Island also levy income taxes on individuals based on sliding scales which differ in each province. (No personal income taxes are levied by the Provinces of Quebec, New Brunswick and Nova Scotia). In Ontario, Manitoba and Prince Edward Island the Federal income tax may be deducted in computing the net income subject to the provincial tax. No such deductions may be made in British Columbia, Alberta or Saskatchewan where a man's total income is subject to a double tax (Federal and Provincial). This results in high total taxes in the higher income brackets in these three provinces.

The City of Montreal levies an income tax based on percentages of the tax payable to the Dominion Government by the individual concerned, as follows:

- (a) 10% of the Dominion tax if the latter does not exceed \$200
- (b) 15% of the Dominion tax if the latter exceeds \$200 but does not exceed \$400
- (c) 20% of the Dominion tax if the latter exceeds \$400.

A comparison of the different rates of income tax payable by residents of the various provinces is given in the following table:

INCOME TAX SUCCESSION DUTIES

TABLE 8 — Percentages of the Total Income Taxes (Dominion and Provincial) to Gross Income by Provinces in the Year 1937

Gross income	Dominion alone ²⁰	B.C.	Alberta	Sask.	Man.	Ont.	P.E.I.
\$ 5,000	2.52%	4.52%	4.02%	4.77%	5.65%	3.65%	5.93%
10,000	6.51	11.56	11.41	11.39	11.84	8.78	11.18
15,000	9.94	18.34	17.37	17.41	17.08	13.11	16.24
25,000	15.92	28.80	28.85	28.33	25.94	20.49	24.32
50,000	23.92	41.91	45.32	42.57	37.52	30.29	31.53
100,000	32.75	55.74	58.45	58.46	48.33	40.11	39.47
250,000	46.41	72.41	74.69	80.00	63.13	54.36	51.77
500,000	55.78	82.78	84.92	91.99	72.25	63.62	60.20
1,000,000	62.54	90.04	92.11	100.07	78.41	70.24	66.28
2,000,000	65.92	93.67	95.70	104.11	82.09	74.01	69.32
5,000,000	67.95	95.85	97.86	106.53	84.46	76.34	71.15
10,000,000	68.62	96.57	98.58	107.34	85.24	77.12	71.76

The following comparison of net incomes after taxes in four of the provinces should give a sufficient example of the effect of these rates on the higher income brackets:

TABLE 9 — Net Income after Income Taxes in 1937 in Four Provinces

Gross income	Alberta	Saskatchewan	Ontario	Quebec
\$ 50,000	\$27,340.50	\$28,713.35	\$ 34,855.23	\$ 38,040.50
100,000	41,550.50	41,538.10	59,885.42	67,250.50
250,000	63,264.50	49,992.33	114,101.96	133,964.50
500,000	75,420.00	40,022.83	181,897.40	221,120.00
1,000,000	78,941.00		297,554.34	374,641.00

In Saskatchewan the net income after taxes from a gross income of \$250,000 would be approximately \$50,000 or 20%. As the gross income increases above the maximum point the net income tends to decrease and is finally eliminated altogether when the gross income reaches the \$1,000,000 mark. The net income after taxes from a gross income of \$1,000,000 in both British Columbia and Alberta would be slightly less than \$100,000 or 10%.

There has been a considerable increase in personal income taxes in recent years, particularly in Canada and the United States. The increase in the Dominion Federal tax alone in the last ten years is shown by the following table:

²⁰This is the tax payable by residents of the Provinces of New Brunswick, Nova Scotia and Quebec (disregarding municipal income taxes including the tax levied by the City of Montreal).

THE CANADIAN CHARTERED ACCOUNTANT

TABLE 10 — Increase in Dominion Income Taxes in Ten Years

Gross income	1928		1937	
	Amount	Per cent. of net income	Amount	Per cent. of net income
\$ 5,000	\$ 32	.64%	\$ 126.00	2.52%
10,000	232	2.32	651.00	6.51
25,000	2,024	8.10	3,979.50	15.92
100,000	19,064	19.06	32,749.50	32.75
1,000,000	362,928	36.29	625,359.00	62.54

There was no provincial income tax in Ontario in 1928, but residents of that province were subject to assessment on their income under the Ontario Assessment Act. In Toronto for example the tax rate was 31.8 mills (for public school supporters). The Province of Ontario introduced an income tax act in 1936 but at the same time the Assessment Act was amended to exclude income so that the tax formerly paid the City of Toronto or other municipalities was discontinued. The combined Dominion and Province of Ontario income taxes in 1937 were substantially higher than the taxes on income levied by the Dominion and the City of Toronto in 1928; this is shown by the following table:

TABLE 11 — Comparison of Total Income Taxes Payable by a Resident of Toronto in 1928 and 1937

Gross income	Dominion and City of Toronto income taxes 1928	Dominion and Province of Ontario income taxes 1937	Increase	Percentage of total income taxes to gross income		
				1928	1937	Increase per cent.
\$ 5,000	\$ 95.60	\$ 182.85	\$ 87.25	1.91%	3.65%	91.27%
10,000	454.60	878.45	423.85	4.55	8.78	93.24
15,000	1,013.60	1,966.63	953.03	6.76	13.11	94.02
25,000	2,723.60	5,121.75	2,398.15	10.89	20.49	88.04
50,000	8,198.60	15,144.77	6,946.17	16.39	30.29	84.59
100,000	22,148.60	40,114.58	17,965.98	22.15	40.11	81.12
250,000	76,926.60	135,898.04	58,971.44	30.77	54.36	76.68
1,000,000	394,632.60	702,445.66	307,813.06	39.46	70.24	78.01
10,000,000	4,280,832.60	7,711,913.48	3,431,080.88	42.81	77.12	80.12

It will be seen that the income taxes have increased during the ten-year period 1928 to 1937 by from 94.02% on gross incomes of \$15,000 to 76.68% on gross incomes of \$250,000 and 78.01% on \$1,000,000 incomes.

Succession Duties and Estate Taxes

Table 3 shows that estate duties contribute 9.6% of the total tax revenues of governments in Great Britain. The corresponding percentage in the United States is 3.2%. In Canada estate duties are collected by the provinces, not

by the Federal Government; the rates on large estates are lower than in Great Britain or the United States and in 1935 receipts from estate duties represented only 2.6% of the total tax collections by all governments in Canada. In Great Britain all estate duties are collected by the Exchequer. In the United States the Federal government collects estate taxes and additional succession duties or estate taxes are levied by every State with the exception of Nevada.

Estate taxes and succession duties, the so-called "death taxes" are of two kinds, both of which are usually based upon a sliding scale which increases with the amount involved. The first are estate taxes levied on the gross amount of the estate including in some cases the amount of gifts made prior to the date of death; the second are inheritance taxes levied on the amount received by each beneficiary. Both forms of tax are collected in Great Britain, in most of the provinces of Canada and in some of the States of the Union.

The Province of Ontario imposes both forms of tax which are based upon the aggregate value of the estate, the amount passing to each beneficiary and the relationship of the beneficiary to the testator. The latter is divided into the following three categories:

- (1) Grandfather, grandmother, father, mother, husband, wife, child, son-in-law or daughter-in-law (where the aggregate value of the estate exceeds \$25,000)
- (2) A lineal descendant other than those enumerated in (1) above or to a brother or sister or a descendant of such brother or sister or a brother or sister of the father or mother of the deceased or a descendant of such last mentioned brother or sister (where the aggregate value of the estate exceeds \$10,000)
- (3) Persons other than those enumerated in (1) and (2) above (where the aggregate value of the estate exceeds \$5,000).

The rates on property passing to persons in category (1) are less than those applicable to category (2); similarly the rates applicable to property passing to persons in category (2) are less than those applicable to category

(3). 15% is added to the amount of the tax calculated according to the basis described above.

The tax is levied on the amount of the assets of the deceased at the time of his death plus the amount of transfers of property prior to his death. The principal exemptions and allowances under the present Act are as follows:

- (a) No duty is leviable where the whole value of any property passing to any one person does not exceed \$500
- (b) Gifts to religious, charitable or educational organizations for work in Ontario
- (c) Expenditures for necessities or education for any member of the deceased's family if such member were dependent upon the deceased
- (d) Gifts to a member of the deceased's family made ten years before his death
- (e) Certain annuities payable to the deceased's father, mother, brother, sister or child to the extent of \$1,200 per annum in respect of any one person and to \$2,400 per annum in the aggregate
- (f) Gifts up to an aggregate amount of \$20,000 to the deceased's father, mother, child, son-in-law or daughter-in-law made three years before his death
- (g) Gifts not exceeding \$500 in the case of any one donee.

There has been a considerable amount of discussion on the subject of the collection of estate or succession duties in Ontario in recent years and the Act has been amended and amplified on several occasions. These amendments have largely had to do with the administration of the Act, and tightening up of the collection of the duties payable. The actual rates of tax have not been increased as much as have personal income taxes in Canada in the last ten years (See Table 11). The following comparison shows the estate taxes payable in Ontario in 1928 and 1937 on the assumption that the total estate passes to one child.

INCOME TAX SUCCESSION DUTIES

TABLE 12 — Comparison of Succession Duties Payable in Ontario in 1928 and 1937—on Estates Passing to One Child

Gross estate	Succession duties		Percentage of gross estate	
	1928	1937	1928	1937
\$ 100,000	\$ 5,500	\$ 8,625	5.5%	8.63%
500,000	57,500	71,875	11.5	14.38
1,000,000	170,000	207,000	17.0	20.7
2,500,000	550,000	690,000	22.0	27.6
10,000,000	2,500,000	3,335,000	25.0	33.35
50,000,000	12,500,000	16,675,000	25.0	33.35

The succession duty acts of the various provinces in Canada are all different and the rates of tax vary from one province to another. This is shown by the following table on the basis of the tax which would be payable if the whole estate passed to one child.

TABLE 13 — Percentage of Estate Taxes to Gross Estates in Canada in 1937 — on Estates Passing to One Child

Gross estate	B.C. Alberta		Sask.	Man.	Ont.	Quebec	New Brunswick	Nova Scotia	P. E.I.
	%	%	%	%	%	%	%	%	%
\$ 100,000	3.75	6.5	5.5	4.0	8.63	4.0	3.3	6.05	5.0
500,000	12.5	13.0	14.3	12.0	14.38	9.0	8.8	13.75	5.0
1,000,000	21.25	16.5	23.65	15.0	20.7	13.0	12.65	20.35	5.0
2,500,000	21.25	19.0	27.5	15.0	27.6	15.0	16.5	26.4	5.0
10,000,000	21.25	19.0	28.6	15.0	33.35	16.5	16.5	29.7	5.0
25,000,000	21.25	19.0	28.6	15.0	33.35	16.5	16.5	29.7	5.0
50,000,000	21.25	19.0	28.6	15.0	33.35	16.5	16.5	29.7	5.0

Generally speaking the rates are higher in Ontario than in the other provinces. Prince Edward Island imposes a tax of 5% only, regardless of the amount involved.

The Province of Ontario collects a tax on all the property of a person domiciled in the province at the time of his death and on all property situated in Ontario passing on the death of any person, whether such person is a resident of the province or not. This situation also applies to the taxes collectible by the other provinces and by the authorities in the United States, with the result that frequently a double tax must be paid on any property situated outside the particular province in which the deceased resided at the time of his death.

The United States Federal tax on estates is based on a sliding scale of from 2% of the first \$10,000 (in excess of the first \$40,000 which is not subject to tax) to 70% of the amount in excess of \$50,000,000. A large percentage of any estate taxes payable to the various State governments

may be deducted from the amount of the Federal estate tax calculated according to the sliding scale referred to. Gifts made more than two years prior to death are not included in the amount of the estate liable to estate taxes. Taxes are payable, however, at the time such gifts are made. These gift taxes are referred to in a later section of this paper. There is no uniformity in the death taxes levied by the various States; as previously stated, some of the States levy both estate and inheritance taxes (as in Ontario)—others impose one tax only.

New York State levies an estate tax based on a sliding scale of from 1% of the first \$150,000 (in excess of the first \$100,000 which is exempt from tax) to 20% of the amount in excess of \$10,100,000.

The Exchequer in Great Britain levies an "estate duty" based on a sliding scale of from 1% of the value of the estate between £100 and £500 (the first £100 is exempt) to 50% of the amount in excess of £2,000,000. In addition to this tax, succession duties or legacy duties are payable but these are relatively small in comparison to the estate duties. The rates of the succession or legacy duties which depend upon the relationship of the beneficiaries and not upon the value of the estate are as follows:

Husband, wife, ancestors and descendants of the deceased	1%
Brothers and sisters and their descendants	5%
Other persons	10%

The effect of the estate duties in Great Britain may be mitigated to a very great extent if a person transfers the whole or part of his property to his children (or anyone else) during his lifetime. No gift taxes are levied on such transfers but in order to escape the estate duty the transfer must have been made more than three years prior to the date of death.

In the following cases estate duty would not be payable on gifts made less than three years prior to the date of death:

- (a) Gifts not exceeding £100—to any one person
- (b) Gifts within the normal expenditure of the testator and reasonable having regard to his income or the circumstances, not being gifts out of capital
- (c) Gifts made in consideration of marriage

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(d) Gifts for charitable purposes need be only one year before death

(e) Absolute immediate gifts to the Treasury in reduction of the National debt.

It is difficult to make comparisons of the amounts of estate taxes which would be imposed in Canada, the United States and Great Britain on any given estate in view of the differences in the types of taxes collected and differences in the laws in regard to gifts made prior to death. In the comparisons given in the following table it has been assumed that the whole estate passes to one child (and that no gifts have been made prior to the date of death):

TABLE 14 — Percentage of Estate Taxes and Succession Duties to Gross Estates in Canada, the United States and Great Britain in 1937 — on Estates Passing to One Child

Amount of estate	Ontario	United States Federal and New York State	Great Britain
\$ 100,000	8.63%	4.20%	8.92%
500,000	14.38	16.58	19.81
1,000,000	20.70	21.93	24.76
2,500,000	27.60	34.68	32.68
10,000,000	33.35	52.04	45.55
25,000,000	33.35	63.81	50.5
50,000,000	33.35	68.40	50.5
100,000,000	33.35	71.20	50.5

It will be seen that estate taxes or succession duties in Ontario (and elsewhere in Canada) are lower than in Great Britain. Estate taxes in the United States on the larger brackets are considerably greater than the comparable taxes in either Ontario or Great Britain. They are lower than in Great Britain on estates of \$1,000,000 or less.

It is dangerous to generalize to too great an extent, however, in comparing the estate taxes in different countries. The following comparison is included to show how the total estate tax in Ontario for example may vary depending upon the relationship of the beneficiaries:

TABLE 15 — Estates Duties Payable in Ontario on a \$1,000,000 Estate in 1937

Relationship of beneficiaries	Total tax	Percentage of gross Estate
(a) One child	\$207,000	20.70%
(b) Five children	151,340	15.13
(c) One sister or brother	299,000	29.9
(d) Five sisters or brothers	241,500	24.15
(e) One stranger	402,500	40.25
(f) Five strangers	402,500	40.25

Gift Taxes

Taxes are levied under the Dominion Income Tax Act at a rate of $2\frac{1}{2}\%$ on gifts up to and including \$25,000. The rates increase on a sliding scale to a maximum of 10% on gifts exceeding \$1,000,000. The tax is levied on the amount of the gifts in any one year and gifts made in preceding years are not taken into account in arriving at the rate which is applicable. These gift taxes do not apply to gifts to any one person in any one year which do not exceed \$1,000 or to gifts over \$1,000 which in the aggregate do not exceed \$4,000 in any one year.

An individual is not taxed upon the income from property which he has given away providing the gift taxes described in the preceding paragraph were paid on the transfer. (This does not apply to the income from property transferred to a wife or husband or to a minor). Payment of these gift taxes to the Dominion Government does not relieve the estate of an individual who was a resident of the Province of Ontario, for example, from paying estate taxes or succession duties on the amount of such gifts (except on gifts to a member of the deceased's family made ten years before his death and certain other classes of gifts referred to on page 278).

In the United States the Federal Government levies taxes on gifts which in the aggregate exceed \$40,000. Gifts of \$5,000 or less to any one individual within any one year are also exempt. The tax is based on a graduated scale of from three quarters of one per cent. on the first \$10,000 of net gifts (after deducting exemptions) to $52\frac{1}{2}\%$ upon the amount of net gifts in excess of \$50,000,000. Gifts made in prior years are taken into account in computing the rate-bracket applicable to the gifts made in the current year. The rates referred to are three quarters of the rates used in computing U.S. Federal estate taxes. (An individual can save somewhat more than 25% of the estate taxes which will be collectible upon his death, however, by taking advantage of the exemption in the case of gifts of \$5,000 or less to any one individual in any one year.) Once these gift taxes are paid the donor is free of income tax in the future on the income from the property transferred and from estate taxes on such property.

New York State does not levy gift taxes.

No gift taxes are levied in Great Britain and as previously stated a person may escape the incidence of the estate duties in that country by transferring his property to his children or other parties providing such transfer is made more than three years before his death. In Great Britain a person does not pay taxes upon the income from property which he has given away.

Other Direct Taxes

CANADA

The taxes levied on corporations by the provincial governments of Canada and the special income tax imposed on individuals in Manitoba are briefly summarized as follows:

(1) Taxes on corporations:

All the provinces levy some form of tax on corporations doing business within their borders. As a rule special taxes are levied on such enterprises as banks, public utility companies, trust and loan companies, insurance companies, land companies, etc., etc. These vary considerably in the different provinces and no attempt has been made to summarize them. The taxes levied on ordinary incorporated companies in the various provinces have been summarized very briefly as follows:

British Columbia—(a) On income—The rates are based on a sliding scale of from 1% on the first \$1,000 to 19% on the nineteenth thousand; when the income exceeds \$19,000 the rate is 10% on the whole net income.

Alberta —(a) 5% on taxable income—it is reported that the rate is to be increased to 10%.
(b) 40 cents per \$1,000 of authorized capital with a minimum of \$10 and a maximum of \$500—10% is added to the tax so calculated.

Saskatchewan —(a) 5% on taxable income.
(b) Annual fee to be prescribed by

the Lieutenant-Governor in Council; ordinarily the tax ranges from \$10 to \$500 depending on the amount of authorized capital.

- Manitoba —(a) 5% of net income — it is reported that the rate is to be increased to 10%.
- Ontario —(a) 1% of net income.
(b) One-tenth of 1% of paid-up capital including surplus and reserves.
(c) \$50 for each office or place of business in Ontario.
- Quebec —(a) 2½% of net income.
(b) One-tenth of 1% of paid-up capital.
(c) \$30 for each place of business in Montreal or Quebec City; \$15 for each place of business elsewhere in the province.
- New Brunswick —(a) Under the Corporations Tax Act of the Province a tax is levied on extra-provincial companies of 1% of the capital employed in the Province; this is subject to a minimum tax of \$100 and a maximum of \$400.
- Nova Scotia —(a) An annual fee under The Domestic, Dominion and Foreign Corporations Act. The fee is based upon the authorized capital of the company.
(b) A tax under The Provincial Revenue (Corporations) Act of one-eighth of 1% of the paid-up capital plus one-tenth of 1% of the amount by which the paid-up capital exceeds \$5,000,000 and does not exceed

\$50,000,000 and one-fifteenth of 1% of the amount by which the paid-up capital exceeds \$50,000,000.

Prince Edward Island —(a) 1% on the first \$500 of net income up to 10% of net income in excess of \$20,000.

(b) One-half of 1% of the assessed value of personal property within the province (this does not include land or real estate).

There is also a tax on "domiciled companies" based upon the amount of paid-up capital.

(2) Special tax on incomes in Manitoba:

The Province of Manitoba levies a tax of 2% on wages, salaries and other income. In the case of wages and salaries the tax is deductible by the employer. Persons in receipt of not more than the following rates of wages or salaries are exempt from this tax:

	Married	Unmarried
Per hour	40 cents	20 cents
Per day	\$3.20	\$1.60
Per month	\$80.00	\$40.00
Per year	\$960.00	\$480.00

THE UNITED STATES

Other important direct taxes levied by the U.S. Federal Government in addition to income taxes, gift taxes and estate taxes, are briefly referred to as follows:

(1) Old age benefits:

A corporation and an individual employer pays a tax of 1% on the salary of each employee up to and including \$3,000. This tax will be increased by one-half of one per cent. every three years until a maximum of 3% is reached in 1949. (This tax is deductible in computing the net income of a corporation). The following "employments" are excepted:

Agricultural labour

Domestic service in a private home

Casual labour not in the course of the employer's trade or business

Service performed by a person who has reached the age of 65

Service performed as an officer or member of the crew of a vessel documented under the laws of the United States or of any foreign country

Service performed in the employ of the United States Government or an instrumentality of the United States

Service performed in the employ of a State, a political sub-division thereof, etc.

Service performed in the employ of charitable organizations.

(2) Unemployment insurance tax:

A corporation and an individual pays a tax which in 1937 amounted to 2% of total payrolls. This is increased to 3% for 1938 and subsequent years.

The following "employments" are excepted:

Agricultural labour

Domestic service in a private home

Service performed as an officer or member of the crew of a vessel on the navigable waters of the United States

Service performed by an individual in the employ of his son, daughter or spouse and service performed by a child under the age of twenty-one in the employ of his father or mother

Service performed in the employ of the United States Government or an instrumentality thereof

Service performed in the employ of a State, a political sub-division thereof, etc.

Service performed in the employ of a charitable organization.

(3) State taxes on corporations:

Each State has its own method of taxing corporations doing business within its boundaries. In some States the tax is based on net income; in others the tax is based on the outstanding capital stock. In New York State the ordinary business corporation pays one of the following taxes. (This does not include real estate companies, hold-

ing companies, transportation and transmission companies, light, heat, water and power companies, insurance companies, banks and trust companies or farmers, fruit-growers and other agricultural companies, all of which pay special taxes):

1. 6% of entire net income without deduction of any Federal income or profit tax or any credit authorized by the Federal Government, or
2. One mill on every dollar of value of stock issued, such value to be not less than the net worth nor less than five dollars per share, or
3. 6% of the amount remaining after deducting 70% of the following: net taxable income or loss plus salaries and other compensation paid to officers and to any stockholder owning in excess of 5% of the issued capital stock less five thousand dollars, or
4. A minimum tax of \$25.

A corporation whose business is conducted partly within and partly without the State pays only a part of one of the foregoing taxes proportionate to the value of its assets in or applicable to New York State, but the minimum tax is in any event \$25.

GREAT BRITAIN

The only other important direct tax in Great Britain is the new "National Defence Contribution." This tax, which is to be in effect for five years from 1st April 1937, is at the rate of 5% of the profits from a trade or business. Certain companies such as railways and other public utilities are exempt. The amount of the "National Defence Contribution" is allowed as a deduction in computing the net income of a company which is subject to income tax.

In the foregoing pages I have tried to sketch the principal differences in the income taxes, estate taxes and gift taxes levied in Canada, the United States and Great Britain and have also referred very briefly to some of the other so-called "direct taxes" in these three countries. It should be remembered when considering these taxes as they are applied in Canada, that if one tax is reduced or altered some other tax must be increased or some other means of obtaining government revenues provided. This is a practical con-

sideration which is sometimes disregarded by those who advocate a reduction in income and estate taxes. Other practical considerations are sometimes overlooked by those who favour increasing the income taxes and succession duties in the higher brackets and by those who are more or less indifferent to such a course being taken. It is only human nature that we should be complacent about any system which tends to tax our neighbours down to our own level of wealth and income. We are inclined to overlook the fact that by doing so we may be indirectly harming ourselves and the community at large.

If we make the taxes too burdensome on the very wealthy in an attempt to get more out of them, they may go away and take their wealth with them. We have had examples in Ontario already of what happens if one tries to kill the goose that lays the golden eggs. But a more serious effect of too high a level of taxes in the higher brackets may be that it discourages men of sound financial position from investing their wealth and their energies in business activities. At the present time a wealthy man may be better off to conserve his capital than to attempt to increase it. If he tries the latter course he must be prepared for the ordinary risks of loss if he is unsuccessful. If he is successful he must be prepared to have a large part of his reward taken from him in the form of taxes. People are not inclined to take chances with their money unless the rewards for success are attractive.

I suggest that these practical considerations be kept in mind in debating the following questions which are presented for discussion:

1. Should the Dominion and Provincial taxes on income be combined?

If not, should the total income tax rates be the same in all provinces?

2. Should the duplications in estate taxes be eliminated and the rates made the same in all provinces?
3. Irrespective of whether the Dominion or the Provincial Governments levy the income and estate taxes, should they all be collected and the acts administered by the Dominion authorities for purposes of economy and uniformity?

4. Should the income tax rates be reduced on the very high incomes (\$50,000 and over)?
If so, should the income tax rates on the lower brackets (\$25,000 and less) be increased and the exemptions reduced to compensate for this loss in revenue?
5. Should the present somewhat complicated manner of computing income taxes in Canada be simplified?
If so, should the British plan be adopted embracing a general rate on all income and a surtax based on a graduated scale of rates?
6. Should a gift tax or a combination of gift taxes be introduced which, once paid, would relieve the individual of future payments of income tax or estate taxes on the property transferred?
If so, should the rates of the gift tax or taxes be sufficiently low to encourage the transfer of property during a man's lifetime?
7. At present charitable donations are allowed as deductions in computing taxable income, but such deduction is limited to 10% of the total income. Should this limitation be dispensed with?
8. The taxes levied on corporations by the different Provincial Governments are dissimilar and different forms must be filed for each province in which business is conducted. It is argued that these taxes are a continual source of irritation to the taxpayer and that they tend to discourage corporations from establishing plants or even doing business in some of the provinces where the taxes are relatively high. In this connection—
 - (a) Should the taxes on capital, place of business, etc. be eliminated?
 - (b) Should the provincial taxes on the incomes of corporations be eliminated?
 - (c) If not, should the methods of establishing the income earned in the various provinces and liable to tax therein be standardized?
9. If at some time in the future it becomes absolutely necessary to increase either the personal income taxes or the estate taxes, would it be preferable to increase the latter as the lesser of two evils?

COMPANY REORGANIZATION

A SCHEME for the alteration of shareholders' rights as between various classes and with respect to the company may well be classed as a hazardous undertaking. The expense involved is inevitably substantial and it may be entirely wasted. Even the most careful canvass of shareholder opinion beforehand may fail to disclose opposition which is ultimately to wreck the scheme. In Ontario of recent months a number of elaborate compromises or arrangements under the Companies Act of the Province or of the Dominion have been abandoned, some because of failure to obtain endorsement by the statutory majority of votes at the special meeting, others because of the refusal of the Court to give its sanction notwithstanding an adequate shareholder approval. An arrangement for National Sewer Pipe Company Limited was rejected by a vote of a substantial majority at the meeting held on 25th February 1938. Simpsons Limited abandoned the application for sanction of its arrangement notwithstanding that the vote in favour at the meeting was considerably in excess of the statutory requirement. Strong opposition developed after the meeting from shareholders who had not been represented at the meeting and who resided abroad.

Recent Decisions

It is a matter for regret that reorganization schemes, which are rendered abortive and objections taken to them, are not preserved of public record. Disregarding features which are individual to the company, its management and business, there are nevertheless lessons to be learned in corporate procedure and shareholder psychology which should be made available for others beyond the immediate group of individuals concerned. The body of reported decisions is steadily growing however. Later will appear references to two decisions of English Courts which, while relatively recent, already are considered classic in their field. In Ontario two very recent decisions will no doubt in due course appear in the Law Reports—*re Langley's Limited*, a decision of the Ontario Court of Appeal rendered on the 24th February 1938, and *re National Grocers Co. Limited*, a decision of Mr. Justice Roach of the Supreme Court of Ontario rendered on 23rd February 1938. It is the purpose of this article to discuss briefly a compromise or arrange-

ment under the Companies Act of the Dominion or of the Province of Ontario.

Attitude of Court

There seems to be no doubt that today the individual investor is more inclined to criticize audibly, and even vociferously, any attempt to alter his contractual rights than for some years. This is probably an indicium of better times—a refusal by the investor to consider that gloom and depression are his lot for the future. Another development is within the courts themselves. Under the Companies Acts, the sanction of court or judge is an essential ingredient. Emphatic statements have been made by the judges as to the proper attitude for the court or judge to take upon the application for such sanction. Briefly, it has been said, the legislation requiring sanction does not require that the court or judge should substitute its or his view as to what is fair and reasonable for that of the shareholders. The court is a referee and is to see that fair play is the order of the day. Fair play requires rigid compliance with statutory requirements, a candid, clear and complete submission of all material facts and a free unimpeded opportunity for shareholders to attend in person or by proxy at meetings to consider the proposed reorganization and there to meet others in the same interest and freely to express their views and their will. If shareholders of a class are dominated by others of the same class who hold shares of another class, the court will endeavour to view the proposals through the eyes of a shareholder of that class and to determine if the mythical reasonable man, a member of the class and acting alone in respect of his interest as such member, could consider the proposals to be in his interest.

Procedure Important

The path of the reorganizer has in it many pitfalls. Changes in capital structure which affect indiscriminately all classes of shareholders may be effected by by-law confirmed, often by special majorities, at meetings specially called to consider them. It is only of recent years (Dominion 1923, Ontario 1928) that any procedure short of unanimous consent was available for forcing upon a dissentient shareholder a compromise or modification of his rights as against the company or in priority to the rights of shareholders of other classes. The reorganization, which might

hereafter be more accurately referred to as a compromise, usually goes forward as a compromise proposed by the company between it and its shareholders or class of shareholders and, if so, it requires the endorsement of the board and, of course, preferably unanimously. As the compromise must be confirmed by supplementary letters patent it should be submitted for approval as to form by the authority which will issue the supplementary letters. The compromise must be *intra vires* with respect to the particular Companies Act in all details. Income tax angles must be considered. If the effects of the compromise upon the company's balance sheet are not readily apparent, the auditors should be asked to certify a balance sheet in *pro forma* or tentative form based upon the last published balance sheet but reflecting the changes to be made.

Notice

An order from a Supreme Court judge is necessary directing the summoning of the meeting. It is common practice that the order should approve the form of notice to be sent out. In one of the recent Ontario cases, *re Langley's Limited*, the sanction of Mr. Justice McTague was revoked by judgment of the Court of Appeal. Mr. Justice Middleton stated that it was unwise for the judge to settle the form of notice. In the same judgment Mr. Justice Masten, while agreeing for other reasons that sanction should be withheld, approved the practice by stating that no objection could be taken to the order directing the summoning of the meeting which order approved the form of notice. In *re Dorman Long & Co.*, an English case, Mr. Justice Maugham (whose appointment as Lord High Chancellor has recently been announced) stated that "the power to summon a meeting involves the power to fix the date of the meeting, the terms and the form of notice."

Proxy

As those promoting the compromise have naturally a desire to see it carried into effect they wish to solicit proxies which may be voted in its favour. Again, it is common practice to forward with the notice forms of proxy for the different classes of shareholders in which the names of shareholders who are members of the particular class have been filled in. This practice was condemned in *re Dairy Corporation of Canada Limited*, an Ontario case arising in

1934. In the other recent Ontario case, *re National Grocers Co. Limited*, the practice was again condemned, the learned judge following the decision in *In re Dairy Corporation of Canada Limited*. In the Langley's Limited case (as previously noted a Court of Appeal decision) Mr. Justice Masten, following English authority, stated that "The proxy itself is not irregular on account of the agent to vote being named in the form as issued." In the National Grocers matter, a provision requiring proxies to be lodged twenty-four hours before the meeting was held to be fatal to sanction in that the provision might have influenced the voting. In the Langley matter, the form of proxies was held to be bad in that, while general in its terms, its use was controlled by a footnote which stated that in the absence of specific instructions to the contrary it would be voted by the person named in favour of the compromise proposed. Advice was given on behalf of the company at the meeting that the person named could not vote the proxies in favour of any alteration or modification to the compromise as proposed except minor changes not of substance. The proxy and the advice were criticized by the Court of Appeal in several respects. The Act involved was the Ontario Act which expressly contemplates alterations or modifications at the meeting and the proxy and advice were held to defeat the intention of the Act. It was also held that if the advice was right the footnote had the same effect as if the proxy itself contained the limitation, and a section of the Ontario Act stipulating that a proxy should contain nothing except the appointment of a proxy and the revocation of the same was violated. The conclusion seems justified that a proxy may not be solicited under the Ontario Act except on the basis that a discretion to vote for alterations or modifications must be conferred on the appointee.

Explanatory Circular

As the compromise is of necessity technical in its wording, an explanatory circular or letter is almost a necessity. The greatest of care is necessary in the drafting of it. It must be candid and comprehensive. No material fact should be withheld. In the Dorman Long matter the circular was criticized for non-disclosure. Compensatory allowances to directors for loss of office under the scheme were involved but not referred to. In the National Grocers case the cir-

cular was held to be deficient in its references to recent progress of the company.

Meeting and Voting

The House of Lords in England in 1937 and the Court of Appeal in 1936 in *Carruth v. Imperial Chemical Industries* emphasized the desirability of holding separate meetings of the different classes of shareholders. Separate meetings had not been held but the court felt that under the circumstances no harm had been done. The courts recognized the importance of enabling a shareholder to meet others in the same interest so as to discuss freely the interests of the class. In the Langley matter Mr. Justice Middleton and Mr. Justice Masten referred to the matter but stated that, while separate meetings of preference and common shareholders had not been held, as no objection had been taken, the irregularity could be disregarded. The vote of the different classes must be separately taken. This is the obvious intent of the sections of the Act and emphasis has been placed on it by many of the decisions. The required majority under both Acts is three-fourths of the shares of each class represented and obviously a poll is essential.

Sanction of Court

Under the Ontario Act, if a single share is voted against the arrangement all shareholders must be notified of the appointment before the judge on the application for sanction. The length of notice, as with the notice of meeting, is fixed having regard to the geographical location of the most remote shareholders. Under the Dominion Act only those who dissented are to be notified of the appointment although all shareholders may attend. The entire procedure and the arrangement are subject to review by the judge. The proceedings are entirely informal and shareholders may be heard either personally or by counsel. It is common practice for the judge to direct that legal costs of all parties must be paid by the company regardless of the decision. Sanction having been obtained, the last step is a petition for supplementary letters patent, the issue of which places the final stamp of approval on the arrangement and makes it binding on all shareholders. If sanction is refused or granted under the Ontario Act, an appeal lies by leave to the Court of Appeal but the judgment of that court is final.

JAMES T. GOW.

THE DOMINION ASSOCIATION OF CHARTERED
ACCOUNTANTS

1937-38

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APRIL, 1938.

GENERAL NOTES

Matters of Interest to Members

Meeting of Executive Committee—The mid-year meeting of the executive committee of The Dominion Association of Chartered Accountants was held at Toronto on 3rd and 4th March. There was a full attendance of the members who are as follows: Frank A. Nightingale, Halifax, President; William E. Hodge, Moose Jaw, Vice-President; George E. Winter, Vancouver, Immediate Past President; Kenneth W. Dalglish, Montreal, Chairman Legislation Committee; Lieut.-Colonel A. E. Nash, Toronto, Chairman Finance Committee; and Austin H. Carr, Toronto, Secretary-Treasurer.

Among the several matters of business assigned to the executive committee by the council at the close of the annual meeting last August was the resolution respecting a standardized educational programme for students. The committee directed its attention to this matter immediately following the annual meeting, and an outline of the present educational programme of provincial Institutes was prepared in the Secretary-Treasurer's office showing in tabulated form the following requirements and other particulars for each Institute: preliminary standing of student, term of articles, instruction offered, subjects required in the primary, intermediate and final examinations, and pass mark. A copy of the outline was sent last fall to the Secretary of each Institute so that the column containing the information for his Institute could be checked. Returns were received from all the Institutes and sufficient information appears now to be in hand for the preparation of a report to the next annual meeting. The executive committee accordingly appointed Messrs. Kris A. Mapp (chairman), William Gray, Winnipeg, W. G. Rowe, Vancouver, and Alex. Ballantyne, Montreal, a committee to study these particulars and to bring in a report to the next annual meeting setting forth in what respect the education of students can be standardized and the nature and scope of further study which may be given to it by a committee consisting of representatives of all nine Institutes.

The possibility of having a uniform examination for provincial Institutes had been considered on previous occasions by a group of the Institutes. Last fall the suggestion that a uniform examination be adopted throughout Canada

was advanced by one of the Western Institutes, and the executive committee accordingly communicated with all the Institutes asking for information and suggestions. The members of the executive committee expressed agreement on the general principle of uniform examinations throughout Canada, and appointed a committee consisting of the members of the committee on the standardized programme of education, together with Kenneth W. Dalglish and Colonel A. E. Nash, to give consideration to the matter and to bring in a report to the 1938 annual meeting at Halifax.

From the date of the establishment of the permanent secretariat of the Association in 1930, the Ontario Institute had kindly placed its Board Room and its facilities at the service of the Association. The executive committee was empowered by the last annual meeting to make arrangements for the renting of space for the office of the Secretary-Treasurer and to provide adequate equipment. Accordingly, on 1st November last space was leased in the Bank of Commerce building, 10 Adelaide Street East, Toronto, and the office was appropriately furnished. A resolution expressing the sincere appreciation and thanks of the Dominion Association to the Ontario Institute for its courtesy, kindness and helpful accommodation during the years was unanimously adopted and was presented by the President, Mr. Nightingale, to the Institute at its mid-winter dinner held on 3rd March.

As an account of the organization and development to date of the provincial Institutes was considered desirable, the executive committee some months ago invited each of the Institutes to prepare such an account for the permanent records of the profession. Committees of most of the Institutes have now been appointed and it is anticipated that interesting and valuable accounts will be in hand in the near future.

Some accounting associations, particularly those in Great Britain, have had in operation for years members' benevolent funds and annuity funds. Some consideration was given by the meeting to the possibility of establishing somewhat similar funds for the members of the profession in Canada, and a committee was named consisting of Colonel Nash (chairman) and Messrs. Dalglish and Winter

to make a study of the subject and to bring in a report to the council during the next annual meeting.

With a view to retaining for the Association the experience of former Presidents, the executive committee will recommend to the next annual meeting that an advisory body of Presidents of the Dominion Association who held office within the previous eight years be formed, the members of such advisory committee to have the privilege of attending meetings of council without the power of voting.

The next annual meeting of the Dominion Association will be held in Halifax, August 22nd to 25th inclusive. The executive committee will meet on the morning of the 22nd, the council in the afternoon and all day the 23rd, and the general sessions on the 24th and 25th. Further particulars will be announced in THE CANADIAN CHARTERED ACCOUNTANT well in advance of the meeting.

At noon on Thursday, March 3rd, the members of the executive committee and the President and Vice-President of the Ontario Institute were guests at a luncheon provided by Colonel Nash at the National Club; and on Friday the members of the executive committee and of the editorial committee were guests at luncheon of Mr. W. J. Saunders, chairman of the magazine committee. On Thursday evening the members were the guests of the Ontario Institute at their mid-year dinner.

Our Contributors This Month

In our issue of May 1937 WALTER LOCKHART GORDON wrote on personal income taxes and succession duties. We are pleased to bring to our readers this month his address on income taxes, succession duties and other direct taxes in Canada, the United States and Great Britain, which he gave on 3rd March last to the Monetary Group of the Toronto Branch of the Institute of International Affairs. Mr. Gordon is a graduate of Upper Canada College and of the Royal Military College, Kingston, and served his apprenticeship in the office of Clarkson, Gordon, Dilworth and Nash, chartered accountants, Toronto. He passed the final examinations of the Institute of Chartered Accountants of Ontario in 1931 and became a partner of the above firm in 1935.

JAMES KILPATRICK, whose address on the prospectuses

of public companies we have the privilege of publishing this month, served his articles with Messrs. David Strathie & Company, chartered accountants, Glasgow, and was admitted a member of the Institute of Accountants and Actuaries in Glasgow in 1912. At the outbreak of the Great War he was with the St. Petersburg office of Messrs. Deloitte, Plender, Griffiths & Company. After training, he was commissioned in 1915 to the Royal Scots Fusiliers and served as a machine gun officer in France, attaining the rank of Captain. He returned to the London office of Messrs. Deloitte, Plender, Griffiths & Company at the beginning of 1919, and was admitted a partner of that firm in 1925.

WALTER LATTMAN who is Assistant to the General Manager of Massey-Harris Co., Limited, Toronto, was born in Switzerland, and is a graduate of the University of Switzerland. He has had eighteen years' experience in export business, can speak seven languages, and has travelled in practically every country in the world. For the past fifteen months he has resided in Canada.

HOWARD I. ROSS, whose essay published this month won one of the prizes in The 1937 Essay Competition, was born in Montreal in 1907. He is a graduate in Arts of McGill University (1930), and obtained the degree of Master of Arts from Oxford University in 1932. Upon his return to Canada in the latter year, he entered the office of P. S. Ross & Sons, chartered accountants, Montreal, of which firm his grandfather was the founder. In May 1937 he passed the examinations of the Society of Chartered Accountants of the Province of Quebec.

Filing 1937 Income Tax Returns

Since the advent of the month of April causes individuals and corporations to become income tax conscious, the following particulars about filing returns, taken from the March issue of *The National Revenue Review*, should be helpful to readers. The income tax Form indicated should be filed by Canadian taxpayers with the Inspector of Income Tax in the district in which they reside.

THE CANADIAN CHARTERED ACCOUNTANT

Forms used by	Description of form	Nature of Form	Due to be filed	Penalty
Individuals	T. 1	Income received for the calendar year.	On or before the 30th April.	5 % of the amount of the tax. Maximum \$500.
Farmers and Ranchers	T. 1A	Income received for the calendar year.	On or before the 30th April.	5 % of the amount of the tax. Maximum \$500.
Corporations	T. 2	Income received for the fiscal year.	Within four months from the close of the fiscal year.	5 % of the amount of the tax. Maximum \$500.

TAXES TO BE WITHHELD AT SOURCE

Corporations, associations, Dominion and Provincial Governments, municipalities, religious and charitable institutions and, in short, those persons who may be under obligations to pay interest, dividends, rentals and royalties.	700	Remittance and particulars of 12½ % tax deducted from rentals paid or credited to non-residents.	Within one week next succeeding the week payment has been made or credited.	\$10 per day. Maximum \$50. See note below.
	701	Remittance and particulars of 12½ % tax deducted from royalties paid or credited to non-residents.	Within one week next succeeding the week payment has been made or credited.	\$10 per day. Maximum \$50. See note below.
	603	Remittance and particulars of 5 % tax deducted from dividends and interest.	Within one month of payment of the dividend or interest.	See note below.

Note.—For failure to deduct the debtor is liable for the tax with interest at 10% per annum. For failure to remit a further penalty of 10% of the amount collected or withheld together with interest at 10% per annum until paid.

The Provinces of Ontario, Manitoba and Prince Edward Island have entered into arrangements with the Dominion government whereby their income tax laws are to be administered by the Dominion. Following is an announcement in respect thereto:

The Income Tax Act of Ontario, 1936—This Act is administered by the Income Tax Division of the Department of National Revenue. The Ontario Income Tax is payable by individuals residing in, employed in, or carrying on business in Ontario. Combined Dominion-Ontario forms are provided for such persons and the taxpayer is required to file this return on or before the last day of April each year. It is necessary for each taxpayer to estimate and pay the tax in the same manner as is required by the Dominion. The Ontario rate of tax is presently one-half of the Dominion rate and the basis of determination of the income is as required by the Dominion, with the exception that income from Dominion of Canada tax free bonds is not exempt under the Ontario Act, but there is an allowance of the Dominion tax for the same period as a deduction from the income for Ontario tax purposes.

The Income Taxation Act, Manitoba—This Act is administered

by the Income Tax Division of the Department of National Revenue. The Manitoba income tax is payable by individuals residing in, employed in, or carrying on business in the Province of Manitoba. The exemptions are: \$750 for unmarried persons; \$1,500 for married persons.

Combined Dominion-Manitoba Forms (T. 1 Dom.-Man.) are provided for such persons, and the taxpayer is required to file this return on or before the last day of April each year. It is necessary for each taxpayer to estimate and pay the tax in the same manner as is required by the Dominion of Canada. The Manitoba rate of tax is not a proportionate rate of the Dominion tax; the basis of determination is however shown on the dual Income Tax forms.

The Income Tax Act, Prince Edward Island—This Act is administered by the Income Tax Division of the Department of National Revenue. The Prince Edward Island tax is payable by individuals, residing in, employed in, or carrying on business in the Province of Prince Edward Island. The exemptions are: \$750 for unmarried persons; \$1,000 for married persons; unless husband or wife has an income in excess of \$750, in which case the exemption is \$750 each. In lieu of the exemptions just referred to for Province of Prince Edward Island Income Tax purposes only, either a soldier, sailor or nurse who took part in the South African campaign, 1899-1901, or who served overseas during the Great War, is entitled to the following exemptions: (a) where married—\$1,500; (b) where unmarried—\$1,250.

Combined Dominion-Prince Edward Island Forms (T. 1 Dom.-P.E.I.) are provided for such persons, and the taxpayer is required to file this return on or before the last day of April each year. It is necessary for each taxpayer to estimate and pay the tax in the same manner as is required by the Dominion of Canada. The Prince Edward Island rate of tax is not a proportionate rate of the Dominion tax; the basis of determination is however shown on the dual Income Tax forms.

While no directions on the matter are given in *The National Revenue Review*, the income tax laws respecting corporations carrying on business in Manitoba or in Prince Edward Island are to be administered by the Dominion. Combined Dominion-Manitoba Forms for corporations (T2-1937—Dom.-Man. Combined) and combined Dominion-Prince Edward Island Forms for corporations (T2-1937—Dom.-P.E.I. Combined) are now available.

Treatment of Inventory Losses by New York Stock Exchange

As a result of the fall in commodity prices during the months prior to the close of 1937, the New York Stock Exchange received a number of requests for advice regarding the treatment in accounting statements of inventory losses and of differences between the present prices and the cost of goods contracted for but not yet received.

The Committee on Stock List made a study of the whole question and, after obtaining advice on the accounting features involved from the Committee on Co-operation with Stock Exchanges of the American Institute of Accountants, sent a letter to the presidents of corporations having securities listed on the Exchange setting out the following treatment of the matter:

Treating, first, the question of annual reports as distinguished from interim reports, we feel that the following practices would be desirable:

(1) That each corporation should clearly advise its stockholders whether, as an incident to the conduct of its business, the corporation does or may enter into future commitments for the purchase and sale of commodities (such as rubber, cotton, wool, sugar, wheat, etc.) to such an extent that the amount of its commitments outstanding is or may at any time become a material fact in the corporation's position.

If stockholders have not already been informed as thus suggested, the information should be given in the next annual report.

If, after having once made a statement on this subject, there should be a change of practice, that fact should be indicated in the annual report next following such change.

(2) (a) If, at the end of any fiscal year, purchase commitment prices exceed current purchase prices to a material extent (assuming that a free market for similar commodities can fairly be said to exist), the corporation should disclose what is the approximate amount of the indicated excess of prospective cost of commodities at commitment prices over the value at market prices, and what amount of reserve has been provided or is available at the close of the fiscal year in respect of such difference. If and to the extent that purchase commitments are offset by firm sales commitments to responsible buyers, no reserve would be necessary, but it would be desirable that this fact should be disclosed.

If prices have fallen, but there is no free market for commodities similar to those covered by commitments, the circumstances should be sufficiently described in the report to make the situation readily understandable to stockholders.

(b) The procedure above outlined (which is analogous to that of valuing inventories at cost or market whichever is lower) is, the committee believes, in accordance with accepted accounting practice.

(3) The Committee recognizes and draws attention to the fact that the existence of commitments in large volume may, in a time of widely fluctuating prices, be a fact of material importance in the financial position of a corporation, even though at the date of the balance sheet market prices may be equal to or greater than commitment prices. It feels, however, that information on this point is not within the scope of the balance sheet or the accounts relative thereto, and that the question whether it should be given, and if so, how, forms a part of the general problem of supplementing annual accounts with other information bearing upon the position or prospects of the corporation, which must be dealt with by corporate executives in accordance with the circumstances of the particular case.

The foregoing has to do primarily with annual reports. It is equally important to stockholders to be advised of the existence of any of the situations herein treated upon the occasion of an interim report. There are, however, three essential differences between interim and annual statements, namely, that the former cover only a fraction of a year, they are less complete, and they are usually unaudited. The Committee on Stock List has frequently pointed out that while it believes quarterly statements to be valuable to investors, there is an ever present danger that undue importance will be attached to them and unwarranted inferences drawn from them. In many cases losses which would be indicated under the foregoing treatments may be so large in proportion to the profit of a short period such as a quarter, that a statement which provided for the loss without indication of that fact, or of the amount of loss provided for, might be as misleading as one which ignored the loss entirely. The quarterly reports should at least show, in the event of the existence of any of the conditions herein treated, whether such conditions have been dealt with, and if so, in what way.

In all of the cases herein treated, whether in annual or in interim reports, executives should determine the precise form of presentation in the light of the facts of the situations of their respective companies, bearing in mind that the object to be sought is the enlightenment of both present and potential stockholders.

Positions Open in Stores and Accounts Branch of Royal Canadian Air Force

We have been asked to draw the attention of our readers to the announcement of the Department of National Defence that it offers for competition vacancies for permanent com-

missions in the Stores and Accounts Branch of the Royal Canadian Air Force. In general terms, to be eligible for consideration candidates must be British subjects, unmarried, medically fit, between 21 and 25 years, and graduates of the Royal Military College, or the applied science, commerce, or arts (in commerce) faculties of a recognized university, or possess certificates of having passed the intermediate accountancy examination set by a Provincial chartered accountants' association. Application forms and further particulars may be obtained from the District Officer Commanding of the district in which the candidate is resident.

British-Italo Trade Pact

According to a news despatch from London on 18th March last, a new trade agreement between Great Britain and Italy was signed that day at the foreign office. It was to become effective 28th March and provides for an increase of about 27½ per cent. in the amount of British goods to be sent to Italy over the old quota fixed in 1936.

A Statement of Accounting Principles

For the information of members, a copy of "A Statement of Accounting Principles" prepared by Messrs. Sanders, Hatfield and Moore and published by the American Institute of Accountants, was sent in February to the reference library of each Provincial Institute. We expect to make further reference to this publication in our next issue.

The Pioneer Laundry Case

The judgment of the Exchequer Court of Canada in the case of Pioneer Laundry and Dry Cleaners Limited, a report of which appeared in our January issue, has been appealed to the Supreme Court of Canada. As soon as the judgment of this court is known a report will be published in

THE CANADIAN CHARTERED ACCOUNTANT.

Howler!

(From a candidate's examination paper)

"As per *Garner v. Murray* decision, if one partner be bankrupt then the others must bear the loss in proportion to their capital at date of disillusionment."

Back Copy Needed

A member who is binding the volumes of THE CANADIAN CHARTERED ACCOUNTANT asks for a copy of the July 1929 issue. Can somebody spare a copy?—*The Editor*.

PROVINCIAL NEWS

BRITISH COLUMBIA

The special committee on Students' Education appointed some time ago by the Council of the Institute of Chartered Accountants of British Columbia has now brought in the following recommendation which was adopted by the Council at its February meeting: "That the British Columbia Institute compile a course of instruction for students to be administered locally and be compulsory with all students."

It is felt that such a course can be of the greatest benefit to the students and, with the law section compiled by a British Columbia barrister, should be of the maximum value in the preparation of the students for their examinations and subsequent professional requirements. The President was empowered to select a committee to prepare such a course.

A report of the Examination Committee was adopted (subject to necessary changes in the by-laws of the Institute) to the effect that the term of service of a student before sitting for the Intermediate Examination be extended from eighteen months to two years; that the Intermediate Examination be made more exacting so as to demand a wider scope of study than now is the case, and that the latter provision become effective with the 1939 examination.

ONTARIO

The annual mid-winter dinner and reception to new members of the Ontario Institute, at which the diplomas and prizes awarded in the last examinations were presented, was held at the Royal York Hotel, Toronto, on Thursday evening, March 3rd. Nearly three hundred attended the gathering and listened with much interest to the address of Dr. Robert C. Wallace, Principal and Vice-Chancellor of Queen's University. A. B. Shepard, F.C.A., President of the Institute, presided and introduced the speakers, and W. G. H. Jephcott, C.A., moved in well chosen words a vote of thanks to Dr. Wallace. Gordon D. Campbell, F.C.A., Vice-President of the Institute, presented the prizes and spoke feelingly on the subject of "Internal Check" whilst recovering certain prizes inadvertently handed to the wrong prize-winners.

The members of the Executive Committee of the Dominion Association then in session in Toronto were welcome guests on this occasion, and Frank A. Nightingale, C.A., President, spoke briefly on the work which they were doing, and, as a surprise, presented to the Ontario Institute a silver rose bowl in recognition of its assistance in past years in furnishing quarters for the secretariat of the Dominion Association.

George Plummer, President of the Students' Association, spoke on matters relating to the reorganization of the Students' Association and acknowledged the assistance cheerfully given at all times by the members of the Institute.

Address of Principal Wallace—The following summary of Dr. Wallace's address has, on request, been kindly furnished by him to the Editorial Committee:

A close relationship of this Institute to Queen's University was formed when in 1921 correspondence courses were established at Queen's for students in Accountancy for Institute examinations. That relationship has grown still closer with the years: and it has been possible as well to give similar service to students in other provinces in Canada. So that I come to you with a point of contact. I wish to express the satisfaction of those who are connected with the work at Queen's with the very fine relationships which have been maintained with the Institute during those years.

The profession has a further interest in Canadian universities in that the Bachelor of Commerce degree is accepted in lieu of the primary examination and the first two years of apprenticeship. I have been reading recently a discussion in *The Accountant* as to the value of university education for the profession of Chartered Accountants. It is not far from the mark to say that university education is designed less for specialized technique than for wider background and interests. In other words, the system of training now in practice—a combination of the theoretical and practical—will make a much more efficient accountant than would university education alone. We fail greatly in our universities, however, if a man who has the opportunity to take both university and practical training will not prove to be wider in his outlook, richer in his contacts, and more influential in his judgments to the extent that he has used the opportunities which his university life provided for him. But only to that extent.

The profession provides that sense of accuracy and direction which is essential in the complicated structure of business and industry in our day. Not only do you show the standing of the operation, be they in industry or in Government: you indicate where the weaknesses are, and how they should be met. You are to the structure of business life as the physician is to the human body: you diagnose and cure; but you are preventive agencies as well. The high standard of ethics which you have incorporated in your Charter and maintain in your practice is an indication of the sense of responsibility which you feel in pointing out without fear or favour the danger signals in the business life of corporations or governments.

You are concerned with the statement of profit and loss in financial terms. It would be beyond my ability and knowledge to discuss any phase of your problems. But there are wider aspects of profit and loss in which we are interested together. They deal with values less tangible than coin of the realm, but none the less real. How are we in balance in our national life? and how are we in the wider field of world affairs?

The economic relationships of federal and provincial governments in Canada are being explored by an important Commission: and members of your profession are giving assistance in this work. But in this exploration other weaknesses are coming to light. The national life in Canada is normally under strain, because of the conflict of interest, so difficult to adjust, in a country of such wide diversity and varied resources. I should hesitate to affirm that in this regard the situation has shown a favourable tendency. There have been disruptive forces which show elements of danger to national unity. This is a time to

look carefully at the weaknesses, to explore their causes, and to seek reasonable solutions. They will not be easy solutions: but the unity of our whole Canadian life is, to most of us, a fundamental consideration.

In the international field the last few years have shown not a profit, but a definite loss. We have gone backward, and we do not seem to be able to trace our losses. It is a difficult job, this living together in our little world. It has been too difficult for us as yet, though over the years we have learned many things. We go forward, and now and then we reverse our steps. In checking up values in the business of living and working together, there is an international deficit. It may well be that we have been too unwilling to go to the root of the difficulties, and to show a disposition to eradicate the trouble. I speak of difficult matters: but I have confidence that in the long run, and it may take much time, good sense, kindliness, and a sense of the kinship of human desires and aspirations the world over will prevail. It will prevail only in so far as we have the will to that end, and use our intelligence to find the way. That is the challenge to our time.

PERSONALS

Announcement has been made of the appointment of C. A. Glover, member of the Institute of Chartered Accountants of Manitoba, as Comptroller General of the Province of Manitoba, the appointment to take effect on May 1st, the beginning of the fiscal year 1938-39. Mr. Glover served his articles with Messrs. George A. Touche & Co., Winnipeg, in 1925-30, and after being admitted a member of the Institute in 1930 became internal auditor of Canadian Co-operative Wheat Producers, Limited. For a time he was engaged by the City of Winnipeg Audit Department and is at present assistant treasurer of the Canadian Wheat Board.

Messrs. Price, Waterhouse & Co., Vancouver, announce the admission to partnership of Mr. Edward H. Cotter, Chartered Accountant, who for some years past has been associated with the firm in a managerial capacity.

TERMINOLOGY DEPARTMENT

The articles in this Department, unless otherwise stated, are originally written by the Chairman of the Terminology Committee and submitted to the members thereof; they are afterwards revised by him after consideration of suggestions made by the members.

If it should be thought that any articles include too much primary or elementary matter, readers are asked to realize that the Committee hopes these articles will be of especial value to Students-in-Accounts; and it is believed that, to impart a thorough understanding too much emphasis cannot be placed on the fundamental principles on which the ideas connoted in the term defined are based.

(Continued from March issue)

Consolidated Income Statement: A statement made from the Profit and Loss Accounts of a parent company and its subsidiaries, in which, after the elimination of inter-company transactions, the various items are combined so as to show the results of the companies' business as of a single unit; also used in connection with a head office and branches.

Consolidated Surplus: The combined surplus of a parent company with its subsidiaries after eliminating the interest of minority shareholders in the subsidiaries and any amount paid for existing surplus on their acquisition by the parent company.

Constituent Company: One in a group of affiliated companies.

Contingent Account: A contingency is "something that may happen; a possible occurrence; a fortuitous event; or one which may occur" (Annandale). A contingent account is a reservation against possible losses or unusual liabilities, and strictly should only be used for matters out of the ordinary, although it is not unknown for business concerns to use this term for such ordinary reservations as for bad debts, etc. It has been said that a contingency is something outside the control of the person affected, and this would appear to be a good rule to follow in using the term.

Contingent Liability: A liability contingent on the happening or non-happening of some event, e.g., the non-payment of a note or bill on which an accommodation endorsement has been given; the claiming from a surety under a defaulted contract or bond; the non-payment by the debtors of discounted notes. The term is not intended to cover definite liabilities, even though their amounts are undetermined, e.g., uncalled subscriptions on shares held; expected costs of conducting a law suit, etc.

Correcting Entries: See "Closing Entries."

Corporation: A corporation is a legal "person" created by Act of Parliament or a Provincial Legislature or under the provisions either of the Dominion or a Provincial Companies Act. A corporation may consist of one or more members, but is absolutely distinct from the persons composing it. While all incorporated bodies are corporations, it is usual to use the term only for those bodies formed by Act of Parliament or a Provincial Legislature, as distinct from joint stock companies formed under the provisions of one of the Companies Acts.

Corporations with one member only are known as "Corporations Sole," e.g., The King, a Bishop, etc. In effect the corporation refers to the office rather than to its holder. Other corporations are "Corporation Aggregate."

The above applies to Canada. It should be noted that in Great Britain there is a marked distinction between Corporations and Joint Stock Companies; the former being those bodies created by Act of Parliament or charter of incorporation from the Crown, the latter those created under the Companies Act. Corporations in Great Britain cease to exist only by surrender to the Crown; companies by winding-up.

A corporation must possess a distinctive name. It has perpetual succession, and a common seal is a necessity to authenticate its acts.

Cost Accounting: A branch of accounting designed to determine costs of production of goods and merchandise, especially in a manufacturing plant. Latterly it is being extended to cover costs of services and even financial transactions.

Cost or Market; whichever is lower: A method of valuing stock in trade at the end of the financial year, wherein the lower of cost or market value is used for the individual articles listed in the inventory.

Credit: 1. The right hand side of a ledger account, representing something "received"; generally speaking, in a nominal account, a profit; in a personal account, cash, merchandise, services or other matters of value; in a property account, either a sale is indicated or a reduction in value.

2. Used to represent one's standing in business; the business world's belief in one's ability to keep one's engagements.

Cum Dividend (abbr. "cum div."): A term used in connection with the market price of shares on which a dividend has been declared, indicating that the purchaser is also buying the dividend, which is included in the price. See "Ex Dividend."

Cumulative Preferred Capital: Capital issued with a preferential claim of a regular fixed dividend to be paid before common stockholders may participate, which dividend will accumulate during the periods in which, for any reason, it may not be paid. Any such arrears must be paid before common stockholders can benefit, subject to any special conditions or reservations contained in the company's charter or memorandum of association.

Current Account: (1) See "Account Current." (2) A personal account which is within the terms of the contract, i.e., not overdue. (3) In a bank the customer's regular business or "cheque" account as distinct from "Savings" account in which cheque transactions are either barred or limited.

Current Assets: Those assets of a concern which consist of the merchandise in which it deals, with the debtors' accounts arising from such dealings, and also cash and bank accounts; in contrast to "Fixed Assets" which consist of the buildings, plant, machinery, etc., with which business is carried on, and are not as such intended for sale. See "Working Capital," "Liquid Position."

Current Liabilities: Those liabilities which must be met within a comparatively short period (a year usually), as distinguished from those contracted for long terms, such as bonds or mortgages.

STUDENTS' DEPARTMENT

R. G. H. SMALLS, C.A., Editor

NOTES AND COMMENT

It is noticeable from the published accounts of corporations in the United States that the Application of Funds Statement is finding increasing popularity in that country, and it may well be that this lead will be followed by Canadian companies. Some of our readers will remember that Mr. G. O. May in his address¹ to the mid-winter meeting of the Institute of Chartered Accountants of Ontario last year placed this type of statement ahead of the balance sheet in usefulness to shareholders and management. "This (statement)," he said, "is of very great value for a reason which it may be worth while to emphasize. In the attempt to make the income account reflect earning capacity rather than the actual receipts and expenses of the year by the use of estimates, accruals etc., the income account gets rather away from the cash basis. The statement of resources and the disposition of them answers the question of what has become of the cash which is a vital question in relation to the availability of the income shown in the income account for distribution by way of dividends." He might have added that the statement also reveals very clearly any tendency on the part of management to expand the capital assets at the expense of liquid resources needed for use as working capital or for future dividend payments.

The disposal statement may be illustrated by the two following examples prepared from the balance sheets and income statements of Canadian companies of which A was a retail distributing concern, B an industrial concern.

A

<i>Funds Provided</i>		<i>Funds Applied</i>	
Operating profit	\$1,102,000	Dividends paid	\$ 932,000
Depreciation charged..	198,000	Fixed assets bought ..	375,000
	<u>1,300,000</u>		
Decrease in working capital	7,000		
	<u>\$1,307,000</u>		<u>\$1,307,000</u>

¹Reproduced in *The Canadian Chartered Accountant*, Vol. XXX, p. 295.

STUDENTS' DEPARTMENT

B

Operating profit	\$2,887,000	Dividends paid	\$2,180,000
Depreciation charged..	1,495,000	Funded debt reduced ..	93,000
		Fixed assets bought ..	1,200,000
			<hr/> 3,473,000
		Increase in working capital	909,000
	<hr/> \$4,382,000		<hr/> \$4,382,000

The most satisfactory explanation and illustration of the method of preparing the disposal statement with which we are acquainted is that of Montgomery² since it emphasizes the importance of reducing the statement to its simplest possible terms (like those of A and B companies above) and of using supporting schedules for any detail.

One mistake often made by the student is to confuse the disposal statement with a mere summation of the amounts by which, as between two given dates, the various items on the two sides of the balance sheet have increased or decreased. Such a statement is merely the first step in the preparation of a disposal statement and taken by itself is quite unintelligible and useless. A second mistake is the failure to realize that charges not involving cash receipts or outgo, like appropriations to profit reserves and revaluations of fixed assets, do not affect nor find any place in the disposal statement.

As a stimulating pastime (if nothing more) we commend to our student readers the preparation of disposal statements for companies on whose accounts they have been engaged or in which they are otherwise interested.

* * *

CORRESPONDENCE

March 5, 1938.

The Editor,
The Students' Department.

Dear Sir:

A and B are partners in a firm, with capital of \$60,000.00 and \$20,000.00 respectively, sharing profits in that proportion.

They decide to take one half of the profits each in future.

For that purpose, A reduces his capital to \$40,000, and lends the other \$20,000 to B, thereby increasing B's capital to \$40,000.

Is there any method by which accounts can be kept in the firm's books, showing A with a credit of \$20,000 and B with a debit of

²Montgomery, *Auditing Theory and Practice*, (Ronald), Fifth Edition, pp. 679-682.

\$20,000, in addition, of course, to the two credit accounts of \$40,000 each, capital?

Supposing a surplus of undrawn profits has accumulated—A with \$10,000 and B with \$15,000.

How can B pay \$5,000 to A—not drawing cash—for the purpose of reducing his indebtedness to A from \$20,000 to \$15,000?

Yours very truly,
P. Q.

EDITOR'S NOTE:

It is not possible to record on the books of the partnership the private indebtedness of B to A which would result from A lending \$20,000 to B. The reason for this is that the books and the balance sheet of a partnership business are capable of recording only the relationships of the firm as a firm to individuals whether partners or outsiders. Moreover for purposes of distinguishing between the assets available to creditors of the joint or partnership estate and of the separate estate of each member of a partnership it is essential that the private affairs of each partner should be kept quite distinct from the joint affairs of the partnership. The partnership books will accordingly show A Capital, \$40,000 and B Capital \$40,000, whilst the books of the separate estate of A will show assets of \$40,000 investment in the partnership business and \$20,000 loan to B, and the books of the separate estate of B will show an asset of \$40,000 investment in the partnership and a liability of \$20,000 borrowed from A.

There is no procedure by which B can pay \$5,000 to A otherwise than by the withdrawal of cash from the partnership business. However, there is nothing to prevent an agreement being reached between A and B that \$5,000 (or any other amount for that matter) should be transferred from the credit of B's Drawings Account to the credit of A's Drawings Account. On the books of the separate estate of each partner this transfer would be recorded as a partial discharge of the indebtedness of B to A on Loan Account. It must be supposed of course in the circumstances of the second question that on the books of the separate estate of each partner the undrawn profits would appear as a part of the investment in the business. Accordingly on A's books the investment in the firm would be increased by \$5,000 and the loan to B decreased by like amount, whilst on B's books the investment in the business would be reduced by \$5,000 and the liability to A would be reduced by like amount.

STUDENTS' ASSOCIATION NOTES

BRITISH COLUMBIA

The student classes commenced in February and are now well under way. The lectures this year have a greater enrolment than previously.

The social activities of the Students' Society seem to be gaining in popularity. On Wednesday, March 9th, a bowling tourney organized by the Society was held after the class for the evening ended. After a very exciting match Mr. Norman Cowan was declared the winner, with highest score of 280. Mr. Ken Atkinson was runner-up.

PROVINCE OF QUEBEC

The members of the Chartered Accountant Students' Society of the Province of Quebec numbering about seventy-five wrote the spring test examinations, which were held at Montreal and Quebec on the 19th and 26th of March. Prizes are to be awarded after the results of the tests are known, and competition should be keen. Early in April the names of the winners will be announced and a discussion of the merits (if any) of the answers will take place.

It is planned to hold an unusual evening during this month, which will take the form of a discussion on Cost Accounting. Four or five speakers will give short ten minute introductions covering, it is hoped, all phases such as the President's, the mill manager's etc. viewpoints, then the meeting will be thrown open for discussion.

While the plans are not definite as yet it seems that our Tennis and Golf Tournaments will be rolling around again soon, and possibly another Smoker will be held after the Final examinations in the early part of May.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by a practising chartered accountant of the Institute from whose examinations the problem is taken and represent his views and opinions. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ALBERTA
FINAL EXAMINATIONS (OLD), APRIL 1937.
AUDITING AND INVESTIGATIONS—Question 1.

1. A client asks you to investigate the accounts of a partnership which requires additional capital for the purpose of enlarging the business. The accounts submitted to you show the following trading results for the past three years:

PROBLEM I.

TRADING AND PROFIT AND LOSS ACCOUNT

		1933	1934	1935
Stock 1st January		\$204,000	\$154,400	\$182,800
Purchases	\$212,000			
Returns	12,000			
		200,000		
Purchases	\$210,850			
Returns	18,000			
			192,850	

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Purchases	\$284,860		
Returns	10,500		
Gross Profit		166,400	88,550
		\$570,400	\$435,800
			\$635,000
Rent, Rates, Taxes, Lighting, Heating Advertising, etc.	\$ 72,200	\$ 36,400	\$ 86,975
Bad Debts	4,400	2,110	1,050
Depreciation	6,600	4,850	9,700
Net Profits	83,200	48,070	84,240
	\$166,400	\$ 91,430	\$181,965
	1933	1934	1935
Sales	\$450,000		
Returns	34,000		
	\$416,000		
Sales	\$288,000		
Returns	35,000		
		\$253,000	
Sales	\$484,000		
Returns	16,000		
Stock 31st Dec.	154,400	182,800	\$468,000
	\$570,400	\$435,800	\$635,000
Gross Profit b/d	\$166,400	\$ 88,550	\$177,840
Dividends on Investments		2,880	4,125
	\$166,400	\$ 91,430	\$181,965

What special investigation, if any, do the above figures require?

Enumerate in detail the special points which occur to you as calling for your attention.

SOLUTION

Special investigation would be necessary on the following points:

(1) **Turnover**—What was the cause of the large fall in 1934, and the still larger increase in 1935? Enquiry should be made with a view to discovering whether any fictitious sales have been entered in the accounts of the last year, or whether the sales include large quantities of goods sent out on sale or return. In this connection, it would be necessary to examine the Goods Outwards Book, the Returns Inwards Book, for the new period, and the customers' accounts in the Debtors' ledger. It would also be necessary to ascertain whether there has been any appreciable rise in the selling price of goods during this year, or whether the firm has experienced a boom in trading owing to abnormal circumstances. Have quantities of "Job" goods been purchased at unusually favourable rates, and disposed of during the year? Has the increase in turnover been brought about by exceptionally large expenditure on advertising? (This supposition would appear to be supported by the increase in expenditure revealed by the Profit and Loss account for 1935, although details thereof are not supplied.)

STUDENTS' DEPARTMENT

Have additional Branches been opened or has output been expended by the installation of new Plant?

(2) **Returns Inwards**—In spite of the increased Sales in 1935, the Returns Inwards have fallen. Explanation should be invited on this point.

(3) **Gross Profit**—The percentages of Gross Profit to Turnover are as follows:—

1933 — 40%; 1934 — 35%; 1935 — 38%.

Enquiry should be made as to the cause of the fluctuations. It should be ascertained whether this is due to variations in buying and/or selling prices, or in the basis of Stock valuation.

(4) **Stock**—The percentage of closing Stock to Turnover in 1934 was 72; whilst in 1933 and 1935 the percentages were 37 and 36 respectively. The notable increase in the 1934 stock would apparently have been occasioned by an unexpected fall in Sales during that year. The Stock Sheets of the three years should be examined in detail to locate, if possible, any variations in the basis of valuation.

(5) **Trade Charges, etc.**—Details of expenditure under this heading should be obtained. Since the standing charges, e.g. Rent, Rates, etc., would normally remain constant, explanation should be required of the cause of the precipitate fall in 1934 and rise in 1935. If expenditure on Advertising had been curtailed in 1934 and resumed on a larger scale in 1935, this might account for the drop in turnover in the former and the rise in the latter year.

(6) **Bad Debts**—The amount of Bad Debts charged to Profit and Loss Account during the three years has progressively declined. Enquiry should be made as to the adequacy of the provision for doubtful debts, particularly in the last year.

(7) **Depreciation**—Particulars of the assets to which this item relates, and the basis on which the provision has been made should be obtained. The large increase in 1935 would suggest, either that an insufficient provision for depreciation in 1934 is being remedied in 1935, or that additional Buildings or Plant have been acquired. Satisfaction should be obtained as to the adequacy of the depreciation written off, and as to the present value of the fixed assets to the business as a going concern.

(8) From what Investments are the Dividends derived? How is it that, in spite of the need of more capital for the business, it has been possible to find sums for investment in the past two years? Is it proposed to realize these investments?

(9) **Generally**—Copies of the Balance Sheets at the end of each of the three years should be called for, and the valuation of the assets examined. If Goodwill appears therein, its value should be tested by reference to the profit earning capacity of the business. The Goodwill contribution required of the new partner should also be tested. Particular attention should be paid to the liabilities, noting whether any are secured and, if so, on what assets? The reason for additional capital being required should be ascertained, and enquiry made as to the capacity of the business to utilize such capital in a profitable manner. The terms of credit granted by the business, and the number of times the capital is capable of being turned over during the year would afford valuable information as to the yield which might be expected upon capital invested in the business. Discreet enquiry should also be made as to the nature of the firm's connection, whether it is a bona-fide trade connection, or whether it comprises any large number of personal acquaintances of the present proprietors, to whom

special terms are given, and whose custom would probably be transferred elsewhere if a change took place in the management of the business.

PROBLEM II

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ALBERTA

FINAL EXAMINATIONS (OLD). APRIL 1937.

AUDITING AND INVESTIGATIONS—Question 2.

2. A Bank has been asked by a commercial company to make an advance of \$50,000.00, and instructs you to investigate and report upon the 31st December, 1935, Balance Sheet of the Company, which is as follows:

ASSETS

Cash on Hand	\$ 4,070	
Accounts Receivable less Reserve for Bad Debts..	108,240	
Merchandise and Work in Progress as Certified by Managing Director	64,920	
Bills Receivable	6,200	
Investments at Cost	16,350	
		\$199,780
Leasehold Premises at Cost. Dec., 1930		31,150
Plant and Machinery at Cost, less Depreciation ..		47,850
Goodwill, at Cost		30,000
		<u>\$308,780</u>

LIABILITIES

Accounts Payable	\$ 49,210	
Bank Loan	6,335	
		\$ 55,545
Share Capital:		
Authorized and Issued, 50,000 Ordinary Shares of \$5.00 each, Fully Paid		250,000
Profit and Loss Account		3,235
There is a contingent liability of \$1,750 in respect of bills discounted.		
		<u>\$308,780</u>

The books have been audited by a reputable firm, and your instructions are that it is not necessary to do any detail checking. Describe the course of the investigation you would make and draft your report to the Bank, bringing into it mention of conditions which you might reasonably expect to encounter.

SOLUTION

In view of the fact that the books have been audited by a reputable firm, it is assumed that the Balance Sheet figures may be taken to be correct.

The course of the investigation would be as follows:—

Sundry Creditors—Ascertain to what extent this item is made up of secured creditors, ordinary trade creditors, bills payable, etc. Enquire as to whether any of the liabilities are considerably overdue,

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and whether any proceedings have been commenced against the company for recovery thereof, or judgments obtained. In the case of secured creditors (if any) ascertain the nature of the security given.

Profit and Loss Account—Ascertain how this balance is made up. Ask for production of, and examine the Trading and Profit and Loss Accounts of the past three to five years. Note particularly the trend of the turnover and any fluctuations in the expenditure during those years. Compare the percentages of gross profit to turnover year by year, and enquire into the cause of any marked variations therein. If the profit of the last year has declined, enquire as to the cause thereof, ascertaining if possible, whether it may be due to temporary trade depression, or abnormal causes, and to what extent it may be regarded as permanent. Enquire as to the prospects of the future, and endeavour to obtain an estimate of what the normal expectation of profits may be.

Contingent Liability—Enquire as to the possibility of any liability materializing in respect of the discounted bills.

Goodwill—Ascertain how this item is made up, e.g. whether it represents the price paid for goodwill when the business was purchased, or whether it has been raised in any other way, and test its value by reference to the current earnings of the company.

Enquire to what extent the goodwill may be due to the personal reputation of the directors.

Plant and Machinery—Enquire as to whether adequate depreciation has been provided on this asset, and whether the plant is and is likely to continue to be fully effective, having regard to the possibility of obsolescence, etc.

Leasehold Premises—These appear in the Balance Sheet at cost, no depreciation having been provided. Enquire as to the terms of the lease, and adjust the Balance Sheet value and Profit and Loss Account balance by deducting depreciation on such a scale as will reduce the value of the lease to nil at the expiration of its term.

Sundry Debtors—Enquire as to the term of credit given by the company; as to the extent to which any considerable amount of debts is overdue, and as to the adequacy of the reserve for bad debts.

Stock and Work in Progress—Ascertain the basis of valuation, particularly with regard to work in progress, and the extent to which (if at all) credit has been taken for profit unrealized thereon at the date of the Balance Sheet.

Working Capital—Ascertain the extent to which the liquid assets are sufficient to cover the current liabilities, and the adequacy or otherwise of the margin of working capital remaining. Enquire fully into the cause of the cash shortage, e.g. whether it is due to under-capitalization, long credit being given to debtors, rapid expansion of trade, etc.

REPORT

The Bank.

Dear Sirs:—

Re: _____ Company, Limited.

Pursuant to your instructions, we have investigated the affairs of the above Company, as disclosed by the balance sheet of 31st December 1935, and beg to report as follows:—

(1) The Profit and Loss Account balance is arrived at before providing for depreciation of the leasehold premises.

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(2) The Company's liquid position is made up as follows:—

Sundry debtors	\$108,240.00	
Stock and Work in Progress	64,920.00	
Investments (cost \$16,350) Present Market Value	12,500.00	
Bills Receivable	6,200.00	
Cash in hand	4,070.00	
		<u>\$195,930.00</u>
Less Sundry creditors ..	\$49,210.00	
Bank overdraft ...	6,335.00	55,545.00
		<u>\$140,385.00</u>
Net liquid assets		

This position is satisfactory, except for the shortage of cash which, we are informed, is due primarily to the extended credit given to Sundry Debtors to meet the present intensive competition, and to the difficulty experienced in collecting accounts at the present time. Pressure on debtors to pay their accounts would, it is represented to us, offend many customers, and would injure the Company's trade. As far as we are in a position to judge, the reserve created for bad debts appears to be adequate, and we are assured that the amount shown in the Balance Sheet in respect of Sundry Debtors is the minimum amount which will ultimately be realized.

(3) The Sundry Creditors include liabilities to the extent of \$25,000.00 which are overdue, and in respect of which proceedings have been threatened, although not actually commenced.

(4) The Bills Discounted, in respect of which there was a contingent liability of \$1,750.00 at the date of the Balance Sheet, have since been met, but we understand that Bills to the value of \$4,000.00 have since been discounted and are still outstanding.

(5) The Goodwill appears in the Balance Sheet at the price paid for it when the Company was incorporated. Adequate depreciation has been written off the Plant and Machinery.

(6) The amount of capital represented by fixed and intangible assets is \$109,000.00, being 43.6 per cent. of the issued capital.

(7) We are informed that the losses incurred during the past two years have been brought about by falling commodity prices, and general trade depression, but that every confidence is felt in the ultimate trade recovery. The turnover for the first four months of 1936 has increased by 15 per cent. over that of the corresponding period of 1935.

(8) We are informed that economies are being carried out in the management of the business, which will effect a considerable saving in overhead expenses.

Yours faithfully,
CHARTERED ACCOUNTANTS.

